S241-20.

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REGULATION OF GOVERNMENT SECURITIES

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON

BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 936

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO PROVIDE IMPROVED PROTECTION FOR INVESTORS IN THE GOVERNMENT SECURITIES MARKET, AND FOR OTHER PURPOSES

MAY 9, 1985

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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REGULATION OF GOVERNMENT SECURITIES

THURSDAY, MAY 9, 1985

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met, at 9:30 a.m., in room SD-538, Dirksen Senate Office Building, Senator Alfonse D'Amato (chairman of the subcommittee) presiding.

Present: Senators D'Amato, Hecht, Cranston, Sasser, Riegle, and Proxmire.

Also present: Paula Hawkins, U.S. Senator from the State of Florida, and Bill McCollum, U.S. Representative in Congress from the State of Florida.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. The Subcommittee on Securities will come to order.

S241-18

Today we are holding our second hearing on the Government securities market and at the first hearing on April 17, Chairman John Shad testified on behalf of the SEC. At the April 17 hearing the members of this subcommittee had the opportunity to review the mechanics of the Government securities market and the past failures in this market up to and including ESM Government Securities [ESM], Bevill, Bresler & Schulman. During that hearing it became evident that the recent problems associated with auditing practices and accounting standards.

Since the last hearing I have sent letters to the respective chairmen of the American Institute of Certified Public Accountants and the Financial Accounting Standards Board stating my concern over the recent failures and asking what actions they would be taking in light of the role played by the auditor in the misleading financial statements.

As of this morning, at least to this Senator's knowledge, there has been one additional failure of a Government securities dealer, Parr Securities Corp., a New York broker-dealer, who was put into receivership this week after allegedly entering into more than $16 million in fraudulent transactions. The failure of Parr Securities only reinforces my conclusion that the Government securities market requires some more adequate form of regulation.

Because of the importance of the Government securities market in funding our national debt and conducting monetary policy, it is vital that the integrity of the market be maintained. We are making a serious mistake if we look to preserve the market's liquidity and efficiency while blindly ignoring the need to preserve its integrity.

I recognize that the solutions to the current problem includes customer education, possible changes in accounting practices, as well as a regulatory scheme to require registration and changes in standards for capital adequacy in dealer practices. It is my intent to work toward a legislative solution which would stabilize the Government securities market with a minimal sacrifice in the market's efficiency and liquidity.

Before we have our first witness, I have asked Senator Hawkins, my colleague from the State of Florida, to join us and she will be the first witness. The second witness will be Congressman McCollum, also from the State of Florida.

Senator Proxmire, do you have an opening statement?

[Copy of proposed bill follows:]

99TH CONGRESS
1ST SESSION

S. 936

To amend the Securities Exchange Act of 1934 to provide improved protection for investors in the government securities market, and for other purposes.

IN THE SENATE OF THE UNITED STATES

APRIL 17 (legislative day, APRIL 15), 1985

Mr. CRANSTON (for himself, Mr. PROXMIRE, and Mr. RIEGLE) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Securities Exchange Act of 1934 to provide improved protection for investors in the government securities market, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE AND FINDINGS.

(a) SHORT TITLE.—This Act may be cited as the "Public Securities Act of 1985".

(b) FINDINGS.—The Congress finds that transactions in government securities, as commonly conducted, are affected with a national public interest which makes it necessary—

(1) to provide for the integrity of such transactions and of matters and practices related thereto;

(2) to require appropriate reports;

(3) to remove impediments to and perfect a national system for the clearance and settlement of government security transactions; and

(4) to impose requirements necessary to make such regulation effective,

in order to protect investors, the national credit, and the national banking system, and to insure the maintenance of fair and honest markets in such securities.

TITLE I—ESTABLISHMENT OF A SELF-REGULATORY ORGANIZATION WITH RESPECT TO MUNICIPAL AND GOVERNMENT SECURITIES

SEC. 101. PUBLIC SECURITIES RULEMAKING BOARD.

Section 15B of the Securities Exchange Act of 1934 (15 U.S.C. 78*o*–4), hereafter in this title referred to as "the Act", is amended to read as follows:

"PUBLIC SECURITIES

"SEC. 15B. (a)(1) It shall be unlawful for any public securities dealer (other than one registered as a broker or dealer under section 15 of this title) to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any public security unless such public securities dealer is registered in accordance with this subsection.

"(2)(A) A public securities dealer may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such public securities dealer and any persons associated with such public securities dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within 45 days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Commission shall—

"(i) by order grant registration, or

"(ii) institute proceedings to determine whether registration should be denied.

"(B) Proceedings instituted pursuant to subparagraph (A)(ii) shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within 120 days of the date of the filing of the application for registration. At the conclusion of such proceedings the Commission, by order, shall grant or deny such registration. The Commission may extend the time for the conclusion of such proceedings for up to 90 days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

"(C) The Commission shall grant the registration of a public securities dealer if the Commission finds that the requirements of this section are satisfied. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under subsection (c) of this section.

"(3) Any provision of this title (other than section 5 or paragraph (1) of this subsection) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any registered public securities dealer or any person acting on behalf of such public securities dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

"(4) The Commission, by rule or order, upon its own motion or upon application, may conditionally or unconditionally exempt any broker, dealer, or public securities dealer, or class of brokers, dealers, or public securities dealers from any provision of this section or the rules or regulations thereunder, including the rules of the Public Securities Rulemaking Board, if the Commission finds that such exemption is consistent with the public interest, the protection of investors, and the purposes of this section.

"(b)(1)(A) Not later than 120 days after the date of enactment of the Public Securities Act of 1985, the Commission shall establish a Public Securities Rulemaking Board (hereinafter in this section referred to as the 'Board'), which shall perform the duties set forth in this section.

"(B) The Board shall be composed initially of 17 members appointed by the Commission, after consultation with the Department of the Treasury and the Board of Governors of the Federal Reserve System. The initial members of the Board shall serve as members for a term of two years, and shall consist of—

"(i) five individuals who are not associated with the public securities industry (other than by reason of being under common control with, or indirectly controlling, any broker or dealer which is not a public securities broker or public securities dealer), at least one of whom is representative of investors in public securities and at least one of whom is representative of issuers of municipal securities;

"(ii) six individuals who are associated with and representative of public securities brokers and public securities dealers which are not banks or subsidiaries or departments or divisions of banks or bank holding companies; and "(iii) six individuals who are associated with and representative of public securities dealers which are banks or subsidiaries or departments or divisions of banks or bank holding companies.

"(C) Prior to the expiration of the terms of office of the initial members of the Board, an election shall be held under rules adopted by the Board (pursuant to paragraph (2)(B) of this subsection) of the members to succeed such initial members.

"(2) The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in public securities effected by public securities brokers and public securities dealers. (Such rules are hereinafter collectively referred to in this title as 'rules of the Board'.) The rules of the Board shall comply with the following minimum standards:

"(A) Such rules shall provide that no public securities broker or public securities dealer shall effect any transaction in, or induce or attempt to induce the purchase or sale of, any public security unless such public securities broker or public securities dealer meets such standards of operational capability and such public securities broker or public securities dealer and every natural person associated with such public securities broker or public securities dealer meets such standards of training, experience, competence, and such other qualifications as the Board finds necessary or appropriate in the public interest or for the protection of investors. In connection with the definition and application of such standards, the Board may—

"(i) appropriately classify public securities brokers and public securities dealers (taking into account relevant matters, including types of business done, nature of securities other than public securities sold, and character of business organization), and persons associated with public securities brokers and public securities dealers;

"(ii) specify that all or any portion of such standards shall be applicable to any such class;

"(iii) require persons in any such class to pass tests administered in accordance with subsection (c)(7) of this section; and

"(iv) provide that persons in any such class other than public securities brokers and public securities dealers and partners, officers, and supervisory employees of public securities brokers or public securities dealers, may be qualified solely on the basis of compliance with such standards of training and such other qualifications as the Board finds appropriate.

"(B) Such rules shall establish fair procedures for the nomination and election of members of the Board and assure fair representation in such nominations and elections of public securities brokers and public securities dealers. Such rules shall provide (i) that no public representative on the Board shall be associated with any broker, dealer, or public securities dealer (other than by reason of being under common control with, or indirectly controlling, any broker or dealer which is not a public securities broker or public securities dealer), (ii) that at least one member of the Board is representative of investors in public securities and at least one is representative of issuers of municipal securities, and (iii) that the proportion of public representatives is not materially reduced. Such rules shall also specify the term members shall serve and may alter the number of members which shall constitute the whole Board provided that such number is an odd number.

"(C) Such rules shall (i) be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in public securities, to remove impediments to and perfect the mechanism of a free and open market in public securities, and, in general, to protect investors and the public interest; and (ii) not be designed to permit unfair discrimination between customers, issuers, public securities brokers, or public securities dealers, to fix minimum profits, to impose any schedule or fix rates of commissions, allowances, discounts, or other fees to be charged by public securities brokers or public securities dealers, to regulate by virtue of any authority conferred by this title matters not related to the purposes of this title or the administration of the Board, or to impose any burden on competition not necessary or appropriate in furtherance of the purposes of this title. No such rule shall relate to issuing, bidding, or underwriting procedures fixed or approved by the Department of the Treasury.

"(D) If the Board deems appropriate, such rules shall provide for the arbitration of claims, disputes, and controversies relating to transactions in public securities, except that no person other than a public securities broker, public securities dealer, or person associated with such a public securities broker or public securities dealer may be compelled to submit to such arbitration except at his instance and in accordance with section 29 of this title.

"(E) Such rules shall provide for the periodic examination in accordance with subsection (c)(7) of this section of public securities brokers and public securities dealers to determine compliance with applicable provisions of this title and the rules and regulations thereunder, including the rules of the Board. Such rules shall specify the minimum scope and frequency of such examinations and shall be designed to avoid unnecessary regulatory duplication or undue regulatory burdens for any such public securities broker or public securities dealer.

"(F) Such rules shall include provisions governing the form and content of quotations relating to public securities which may be distributed or published by any public securities broker, public securities dealer, or person associated with such a public securities broker or public securities dealer, and the persons to whom such quotations may be supplied. Such rules relating to quotations shall be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

"(G) Such rules shall prescribe records to be made and kept by public securities brokers and public securities dealers and the periods for which such records shall be preserved.

"(H) Such rules shall define the term "separately identifiable department or division", as that term is used in section 3(a)(44) of this title, in accordance with specified and appropriate standards to assure that a bank is not deemed to be engaged in the business of buying and selling public securities through a separately identifiable department or division unless such department or division is organized and administered so as to permit independent examination and enforcement of applicable provisions of this title and the rules and regulations thereunder, including the rules of the Board. A separately identifiable department or division of a bank may be engaged in activities other than those relating to public securities.

"(I) Such rules shall provide for the operation and administration of the Board, including the selection of a Chairman from among the members of the Board, the compensation of the members of the Board, and the appointment and compensation of such employees, attorneys, and consultants as may be necessary or appropriate to carry out the Board's functions under this section.

"(J) Such rules shall provide that each public securities broker and public securities dealer shall pay to the Board such reasonable fees and charges as may be necessary or appropriate to defray the costs and expenses of operating and administering the Board. Such rules shall specify the amount of such fees and charges.

"(K) Such rules shall establish the terms and conditions under which any municipal securities dealer may sell, or prohibit any municipal securities dealer from selling, any part of a new issue of municipal securities to a municipal securities investment portfolio during the underwriting period.

"(L) As the Board deems necessary or appropriate in order to preserve the financial integrity of the markets for government securities, such rules shall regulate the amount of deposit that shall be initially required and subsequently maintained in connection with the purchase, sale, or carrying of any government security. Such rules and regulations may make appropriate provision with respect to the type of deposit or collateral which shall be furnished; the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchase of securities; the transfer of accounts from one government securities broker or government securities dealer to another; special or different margin requirements for delayed deliveries, short sales, repurchase and reverse repurchase agreements, and arbitrage transactions; the bases and methods to be used in calculating collateral deposits, and margins and market prices; and similar administrative adjustments and details. In developing any such requirements the Board shall consult with the Board of Governors of the Federal Reserve System with respect to the impact and appropriateness of any proposed requirements.

"(3) The Board shall include with the materials submitted to the Commission in a proposed rule change submitted under section 19(b) of this title, the Board's response to any written comments or suggestions submitted by the Board of Governors of the Federal Reserve System or the Department of the Treasury with respect to the impact of the proposed rule on the efficiency, liquidity, or integrity of the markets for government securities.

"(4) Nothing in this section shall be construed to impair or limit the power of the Commission under this title.

"(c)(1) No broker, dealer, or public securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any public security in contravention of any rule of the Board.

"(2) The Commission, by order, shall censure, place limitations on the activities, functions, or operations, suspend for a period not exceeding twelve months, or revoke the registration of any public securities dealer, if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation, is in the public interest and that such public securities dealer, or any person associated with such public securities dealer (whether prior or subsequent to becoming so associated), has committed or omitted any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of section 15(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4).

"(3) Pending final determination whether any registration under this section shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any registered public securities dealer may, upon such terms and conditions as the

Commission may deem necessary in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered public securities dealer is no longer in existence or has ceased to do business as a public securities dealer, the Commission, by order, shall cancel the registration of such public securities dealer.

"(4)(A) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a public securities dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a public securities dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of section 15(b) of this title, has been convicted by any offense specified in subparagraph (B) of such paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4).

"(B) It shall be unlawful for any person as to whom an order entered pursuant to subparagraph (A) of this paragraph or paragraph (5) of this subsection suspending or barring him from being associated with a public securities dealer is in effect willfully to become, or to be, associated with a public securities dealer without the consent of the Commission. It shall be unlawful for any public securities dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such public securities dealer knew, or, in the exercise of reasonable care should have known, of such order.

"(5) With respect to any public securities dealer for which the Commission is not the appropriate regulatory agency, the appropriate regulatory agency for such public securities dealer may sanction any such public securities dealer in the manner and for the reasons specified in paragraph (2) of this subsection and any person associated with such public securities dealer in the manner and for the reasons specified in paragraph (4) of this subsection. In addition, such appropriate regulatory agency may, in accordance with section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), enforce compliance by such public securities dealer or any person associated with such public securities dealer with the provisions of this section, section 17 of this title, the rules of the Board, and the rules of the Commission pertaining to public securities dealers, persons associated with public securities dealers, and transactions in public securities. For purposes of the preceding sentence, any violation of any such provision or rule shall constitute adequate basis for the issuance of any order under section 8 (b) or (c) of the Federal Deposit Insurance Act, and the customers of any such public securities dealer shall be deemed to be 'depositors' as that term is used in section 8(c) of that Act. Nothing in this paragraph shall be construed to affect in any way the powers of such appropriate regulatory agency to proceed against such public securities dealer under any other provision of law.

"(6)(A) The Commission, prior to the entry of an order of investigation, or commencement of any proceedings, against any public securities dealer, or person associated with any public securities dealer, for which the Commission is not the appropriate regulatory agency, for violation of any provision of this section, section 15(c)(1) or 15(c)(2) of this title, or any rule or regulation under any such section, including any rule of the Board, shall (i) give notice to the appropriate regulatory agency for such public securities dealer of the identity of such public securities dealer or person associated with such public securities dealer and the nature of and basis for such proposed action, and (ii) consult with such appropriate regulatory agency concerning the effect of such proposed action on sound banking practices and the feasibility and desirability of coordinating such action with any proceeding or proposed proceeding by such appropriate regulatory agency against such public securities dealer or associated person.

"(B) The appropriate regulatory agency for a public securities dealer (if other than the Commission), prior to the entry of an order of investigation, or commencement of any proceedings, against such public securities dealer or person associated with such public securities dealer, for violation of any provision of this section, rules of the Board, or the rules or regulations of the Commission pertaining to public securities dealers, persons associated with public securities dealers, or transactions in public securities shall (i) give notice to the Commission of the identity of such public securities dealer or person associated with such public securities dealer and the nature of and basis for such proposed action, and (ii) consult with the Commission concerning the effect of such proposed action on the protection of investors and the feasibility and desirability of coordinating such action with any proceeding or proposed proceeding by the Commission against such public securities dealer or associated person.

"(C) Nothing in this paragraph shall be construed to impair or limit (other than by the requirement of prior consultation) the power of the Commission or the appropriate regulatory agency for a public securities dealer to initiate any action of a class described in this paragraph or to affect in any way the power of the Commission or such appropriate regulatory agency to initiate any other action pursuant to this title or any other provision of law.

"(7)(A) Tests required pursuant to subsection (b)(2)(A)(iii) of this section shall be administered by or on behalf of and periodic examinations pursuant to subsection (b)(2)(E) of this section shall be conducted by—

"(i) a registered securities association or (with respect to government securities) a registered national securities exchange, in the case of public securities brokers and public securities dealers who are members of such association or exchange; and

"(ii) the appropriate regulatory agency for any public securities broker or public securities dealer, in the case of all other public securities brokers and public securities dealers.

"(B) An appropriate regulatory agency, registered securities association, or a registered national securities exchange shall make a report of any examination conducted pursuant to subsection (b)(2)(E) of this section and, on request, furnish the Commission a copy thereof and any data supplied to it in connection with such examination. Subject to such limitations as the Commission, by rule, determines to be necessary or appropriate in the public interest or for the protection of investors, the Commission, and each appropriate regulatory agency, registered securities association, and registered securities exchange, shall make available to the Board, on request, a copy of any report concerning examinations of public securities brokers or public securities dealers made pursuant to this paragraph or section 17(e)(3) of this title.

"(8) The Commission is authorized, by order, if in its opinion such action is necessary or appropriate in the public interest for the protection of investors, or otherwise, in furtherance of the purposes of this title to remove from office or censure any member or employee of the Board, who, the Commission finds, on the record after notice and opportunity for hearing, has willfully (A) violated any provision of this title, the rules and regulations thereunder, or the rules of the Board, or (B) abused his authority.

"(d) Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of public securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.".

PART B—CONFORMING AMENDMENTS

SEC. 111. CONFORMING AMENDMENTS: DEFINITIONS.

(a) DEFINITION OF EXEMPTED SECURITY.—Paragraph (12) of section 3(a) of the Act (15 U.S.C. 78c(a)(12)) is amended to read as follows:

"(12)(A) The term 'exempted security' or 'exempted securities' includes—

"(i) government securities, as defined in paragraph (45) of this subsection;

"(ii) municipal securities, as defined in paragraph (29) of this subsection;

"(iii) any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian;

"(iv) any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with a qualified plan as defined in subparagraph (C) of this paragraph; and "(v) such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this title which by their terms do not apply to an 'exempted security' or to 'exempted securities.'

"(B) Notwithstanding clauses (i) and (ii) of subparagraph (A) of this paragraph, government securities and municipal securities shall not be deemed to be 'exempted securities' for the purposes of section 9, 15, 15A, and 17A of this title.

"(C) For purposes of subparagraph (A)(iv) of this paragraph, the term 'qualified plan' means (i) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, (ii) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, or (iii) a governmental plan as defined in section 414(d) of such Code which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (i), (ii), or (iii) of this paragraph which (I) covers employees some or all of whom are employees within the meaning of section 401(c) of such Code, or (II) is a plan funded by an annuity contract described in section 403(b) of such Code.".

(b) DEFINITION OF SELF-REGULATORY ORGANIZATION.—Section 3(a)(26) of the Act is amended by striking out "Municipal Securities Rulemaking Board" inserting in lieu thereof "Public Securities Rulemaking Board".

(c) DEFINITION OF MUNICIPAL SECURITIES DEALER.—Section 3(a)(30) of the Act is amended to read as follows:

"(30) The term 'municipal securities dealer' means a public securities dealer engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise.".

(d) DEFINITION OF PERSON ASSOCIATED WITH A PUBLIC SECURITIES DEALER.—Section 3(a)(32) of the Act is amended—

(1) by striking out "municipal securities dealer" each place it appears and inserting in lieu thereof "public securities dealer";

(2) by striking out "municipal securities dealer's" and inserting in lieu thereof "public securities dealer's"; and

(3) by striking out "with respect to municipal securities" and inserting in lieu thereof "with respect to public securities".

(e) DEFINITIONS OF APPROPRIATE REGULATORY AGENCY—Section 3(a)(34) of the Act is amended—

(1) by striking out "municipal securities dealer" each place it appears in subparagraph (A) and inserting in lieu thereof "public securities dealer"; and

(2) by inserting before the semicolon at the end of subparagraph (A)(ii) the following: ", or a government securities dealer that is not a bank but that is monitored by and reports to the Federal Reserve Bank of New York".

(f) DEFINITION OF STATUTORY DISQUALIFICATION.—Subparagraphs (B) and (C) of section 3(a)(39) of the Act are amended by striking out "municipal securities dealer" each place it appears and inserting in lieu thereof "public securities dealer".

(g) ADDITIONAL DEFINITIONS.—Section 3(a) of the Act is further amended by adding at the end thereof the following new paragraphs:

"(42) The term 'public securities' means securities which are municipal securities or government securities.

"(43) The term 'public securities broker' means a broker engaged in the business of effecting transactions in public securities for the account of others.

"(44) The term 'public securities dealer' means any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling public securities for his own account, through a broker or otherwise, but does not include—

"(A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; or

"(B) a bank, unless the bank is engaged in the business of buying and selling public securities for its own account other than in a fiduciary capacity, through a broker or otherwise.

If the bank is engaged in such business through a separately identifiable department or division (as defined pursuant to section 15B(b)(2)(H) of this title) the department or division and not the bank itself shall be deemed to be the public securities dealer.

"(45) The term 'government securities' means—

"(A) securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; or

"(B) securities which are issued or guaranteed by corporations in which the United States has a direct or indirect interest and which are designated as 'government securities' by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors.

"(46) The term 'government securities broker' means a broker engaged in the business of effecting transactions in government securities for the account of others.

"(47) The term 'government securities dealer' means a public securities dealer engaged in the business of buying and selling government securities for his own account, through a broker or otherwise.".

(h) INAPPLICABILITY OF ACT TO GOVERNMENT ENTITIES.—Subsection (c) of section 3 of the Act is amended to read as follows:

"(c) No provision of this title shall apply to, or be deemed to include—

"(1) any department, agency, corporation, or instrumentality of the United States;

"(2) any corporation in which the United States has a direct or indirect interest whose securities are government securities under subsection (a)(45)(B) of this section; or

"(3) any officer, agent, or employee of any such department, agency, corporation, or instrumentality acting in the course of his official duty as such,

unless such provision makes specific reference to such department, agency, corporation, or instrumentality.".

SEC. 112. ENFORCEMENT BY NATIONAL SECURITIES EXCHANGES.

Paragraphs (1) and (6) of section 6(b) of the Act (15 U.S.C. 78f(b)(1), (6)) are amended by inserting "including the rules of the Public Securities Rulemaking Board," after "regulations thereunder," each place it appears.

SEC. 113. ESTABLISHMENT OF DEPOSIT REQUIREMENTS BY FEDERAL RESERVE BOARD WITH RESPECT TO GOVERNMENT SECURITIES.

Section 7 of the Act (15 U.S.C. 78g) is amended—

(1) by inserting "and to preserve the financial integrity of the markets for government securities" after "carrying of securities" in the first sentence of subsection (a);

(2) by inserting before the period at the end of such sentence the following: "and, if it is deemed necessary by the Board of Governors of the Federal Reserve System, the minimum deposit that shall be required and subsequently maintained in connection with the purchase, sale, or carrying of a government security";

(3) by inserting "on any security other than a government security" after "For the initial extension of credit" in such subsection;

(4) by inserting before "Such rules and regulations" in such subsection the following new sentence: "Should the Board of Governors of the Federal Reserve System determine that it is necessary for it to prescribe requirements with respect to the initial or subsequent mainte-

nance of a deposit in connection with the purchase, sale, or carrying of a government security, such rules and regulations shall require such amount as the Board of Governors of the Federal Reserve System shall deem necessary in order to further the purposes of this title. Any action taken by the Board of Governors of the Federal Reserve System under this authority with respect to a government security shall supercede any rule of the Public Securities Rulemaking Board that is inconsistent therewith.";

(5) by inserting before the period at the end of subsection (b) the following: "or to preserve the financial integrity of the markets for government securities";

(6) by striking out "any broker or dealer" in subsection (c) and inserting in lieu thereof "any broker, dealer, or government securities dealer";

(7) by striking out "broker, or dealer" in subsection (c)(2) and inserting in lieu thereof "broker, dealer, or government securities dealer";

(8) by inserting "or to preserve the financial integrity of the markets for government securities" after "carrying of or trading in securities" in the first sentence of subsection (d);

(9) by striking out "loans made" in the second sentence of such subsection and inserting in lieu thereof "extensions of credit and deposit requirements";

(10) by striking out "brokers, or dealers" in such sentence and inserting in lieu thereof "brokers, dealers, or government securities dealers";

(11) by striking out "to a loan by a bank on a security other than an equity security" in clause (D) of such subsection and inserting in lieu thereof "to an extension of credit by a bank on a security other than an equity security or a government security";

(12) by inserting "(i)" after "means" in subsection (f)(2)(B); and

(13) by inserting before the period at the end of such subsection the following: ", and (ii) a government security".

SEC. 114. ADDITIONAL CONFORMING AMENDMENTS.

(a) REFERENCES TO MUNICIPAL SECURITIES RULEMAKING BOARD.—The Securities Exchange Act of 1934 is further amended by striking out "Municipal Securities Rulemaking Board" each place it appears and inserting in lieu thereof "Public Securites Rulemaking Board".

(b) REFERENCES TO MUNICIPAL SECURITIES AND MUNICIPAL SECURITIES BROKERS AND DEALERS.—The Act is further amended—

(1) by striking out "municipal securities dealer" each place it appears in sections 15(b)(4)(B), 15(b)(4)(C), 15(c)(1), 15(c)(2), 17(a)(1), 17(b), 17(e), 17(f)(1), and 23(b)(3) and inserting in lieu thereof "public securities dealer";

(2) by striking out "municipal securities dealers" each place it appears in sections 23(b)(3) and 23(b)(4)(G) and inserting in lieu thereof "public securities dealers";

(3) by striking out "municipal security" each place it appears in sections 15(c)(1), 15(c)(2), and 15(c)(5) and inserting in lieu thereof "public security";

(4) by striking out "municipal security," in section 15(c)(6); and

(5) by striking out "municipal securities dealer or municipal securities broker" in section 28(b) and inserting in lieu thereof "public securities dealer or public securities broker".

(c) CONSULTATION BY COMMISSION IN RULEMAKING WITH RESPECT TO GOVERNMENT SECURITIES.—Section 15(c)(3) of the Act (15 U.S.C. 78*o*(c)(3)) is amended by adding at the end thereof the following new sentence: "In prescribing rules and regulations under this subsection with respect to capital requirements for government securities dealers, the Commission shall consult with the Board of Governors of the Federal Reserve System and the Department of the Treasury to ensure that such rules and regulations do not impair or otherwise adversely affect the efficiency, liquidity, or integrity of the markets for government securities.".

(e) RULEMAKING BY REGISTERED SECURITIES ASSOCIATIONS.—Section 15A(f) of the Act (15 U.S.C. 78*o*–3(f)) is amended—

(1) by inserting "(1)" after "(f)"; and

(2) by adding at the end thereof the following new paragraphs:

"(2) Nothing in subsections (b)(6), (b)(11), or (g)(3) shall be construed to permit a registered securities association to make rules concerning any transaction by a broker or dealer in any public security.

"(3) Nothing in subsection (e) shall be construed to apply to any transaction in a government security.".

(f) TRANSFER OF AND ACCESS TO DOCUMENTS.—Section 17(c) of the Act (15 U.S.C. 78q(c)) is amended by adding at the end thereof the following new paragraph:

"(4) The Commission or the appropriate regulatory agency may specify that documents required to be filed with the Commission or such agency pursuant to this subsection may be retained by the originating clearing agency, transfer agent, or public securities dealer or filed with another appropriate regulatory agency. The Commission or the appropriate regulatory agency (as the case may be) making such a specification shall continue to have access to the document on request.".

TITLE II—TRANSITIONAL AND SAVINGS PROVISIONS

SEC. 201. TRANSFER AND ALLOCATION OF FUNDS AND PERSONNEL.

The personnel employed in connection with, and the assets, liabilities, contracts, property, records, and unexpended balance of funds employed, held, used, arising from, available to, or to be made available in connection with the Municipal Securities Rulemaking Board shall be transferred to the Public Securities Rulemaking Board for appropriate allocation.

SEC. 202. AGENCY TERMINATION.

On the date of the establishment of the Public Securities Rulemaking Board pursuant to section 15B(b) of the Securities Exchange Act of 1934 (as amended by section 101 of this Act), the Municipal Securities Rulemaking Board shall terminate.

SEC. 203. SAVINGS PROVISIONS.

(a) CONTINUING EFFECT OF AUTHORITIES.—All rules, regulations, interpretations, contracts, policies, procedures, and other actions—

(1) which have been issued, made, granted, or allowed to become effective by the Municipal Securities Rulemaking Board in the performance of functions which are transferred by the amendments made by title I of this Act to the Public Securities Rulemaking Board, and

(2) which are in effect at the time this Act takes effect,

shall continue in effect according to their terms until modified, terminated, superseded, set aside, or revoked in accordance with the law by the Public Securities Rulemaking Board, the Securities and Exchange Commission, or other authorized official, a court of competent jurisdiction, or by operation of law.

(b) EFFECT ON PENDING ADMINISTRATIVE PROCEEDINGS.—(1) The provisions of this Act shall not affect any proceedings, including notices of proposed rulemaking, pending on the effective date of this Act before the Municipal Securities Rulemaking Board or the Securities and Exchange Commission; but such proceedings, to the extent that they relate to functions transferred to the Public Securities Rulemaking Board, shall be continued. Orders shall be issued in such proceedings as if this Act had not been enacted; and orders issued in any such proceedings shall continue in effect until modified, terminated, superseded, or revoked by the

Public Securities Rulemaking Board, the Securities and Exchange Commission, by a court of competent jurisdiction, or by operation of law. Nothing in this subsection shall be deemed to prohibit the discontinuance or modification of any such proceeding under the same terms and conditions and to the same extent that such proceeding could have been discontinued or modified if this Act had not been enacted.

(2) The Securities and Exchange Commission is authorized to promulgate regulations providing for the orderly transfer of proceedings continued under paragraph (1) to the Public Securities Rulemaking Board.

(c) EFFECT ON PENDING JUDICIAL PROCEEDINGS.—Except as provided in subsection (e)—

(1) the provisions of this Act shall not affect suits commenced prior to the effective date of this Act, and

(2) in all such suits, proceedings shall be had, appeals taken, and judgments rendered in the same manner and effect as if this Act had not been enacted.

(d) NONABATEMENT OF PROCEEDINGS.—No suit, action, or other proceeding commenced by or against any officer in the official capacity of such individual as an officer of the Municipal Securities Rulemaking Board or the Securities and Exchange Commission shall abate by reason of the enactment of this Act. No cause of action by or against the Municipal Securities Rulemaking Board or the Securities and

Exchange Commission, or by or against any officer thereof in the official capacity of such officer shall abate by reason of the enactment of this Act.

(e) SUBSTITUTION OF PARTIES.—If, before the date on which this Act takes effect, the Municipal Securities Rulemaking Board, or officer thereof in the official capacity of such officer, is a party to a suit, then such suit shall be continued with the Public Securities Rulemaking Board or other appropriate official of such Board substituted or added as a party.

SEC. 204. REFERENCE.

Reference in any other Federal law or any law, rule, regulation, certificate, directive, instruction, or other official paper in force on the effective date of this Act to the Municipal Securities Rulemaking Board shall be deemed to refer to the Public Securities Rulemaking Board.

TITLE III—EFFECTIVE DATES

SEC. 301. GENERAL EFFECTIVE DATE.

Except as provided in section 302, this Act and the amendments made by this Act shall take effect 180 days after the date of enactment of this Act.

SEC. 302. APPOINTMENT AND RULEMAKING AUTHORITY.

Notwithstanding section 301, effective on the date of enactment of this Act—

(1) the Securities Exchange Commission may—

(A) prescribe rules pursuant to section 15B(a)(2) of the Securities Exchange Act of 1934 (as amended by section 101 of this Act), relating to the registration of public securities dealers;

(B) establish the Public Securities Rulemaking Board pursuant to section 15B(b)(1) of the Securities Exchange Act of 1934 (as so amended); and

(C) prescribe regulations pursuant to section 203(b)(2) of this Act to provide for the orderly transfer of proceedings to such Board;

(2) the Public Securities Rulemaking Board may—

(A) exercise the authority and perform the functions of the Municipal Securities Rulemaking Board; and

(B) prescribe rules pursuant to section 15B(b)(2) of the Securities Exchange Act of 1934 (as so amended); and

(3) the Board of Governors of the Federal Reserve System may prescribe rules and regulations pursuant to section 7 of such Act as amended by section 113 of this Act.

OPENING STATEMENT OF SENATOR PROXMIRE

Senator **Proxmire**. Well, I would just like to welcome the distinguished Senator from Florida back to the committee. She was a wonderful member of the committee. I just wish she weren't so fickle. We missed you and you certainly dolled up the committee as well as added to its intellectual stature.

Senator **D'Amato**. Senator Hecht, do you have an opening statement?

Senator **Proxmire**. I'm not finished. As long as she's not going to stick it to the Wisconsin dairy farmer, and I guess she's not going to do that today, I always love to listen to her—and I just would also like to say, Mr. Chairman, I'm going to have to leave shortly. I hope I can get back. I want very, very much to hear the President of the Federal Reserve Bank of New York, Mr. Corrigan, for whom I have the greatest respect. He's an outstanding figure in this country and a great expert on monetary policy as well as on bank regulation policy and I'm looking forward to reading his testimony if I can't hear it. I will try to get back.

Senator **D'Amato**. Thank you. Senator Hecht.

Senator **Hecht**. Nothing.

Senator **D'Amato**. Senator Hawkins, we are delighted that you are with us. I share my distinguished colleague's regret that you chose to leave our committee for far off pastures. We like having you here even if it's for a short time.

STATEMENT OF PAULA HAWKINS, U.S. SENATOR FROM THE STATE OF FLORIDA

Senator **Hawkins**. Thank you. I must say I have plenty of meetings to attend and I watch everything you do, which should make you very nervous, on this committee.

Senator **Proxmire**. It does.

Senator **Hawkins**. I'd like to commend you, Senator D'Amato, for having this hearing today.

It is a terrible problem, and there's growing tremendous vexation to the citizens in my State and citizens in your State as well as across the United States, the problem we have in the Government securities market.

I know States license them and I'd like to come and talk to you about the Federal controls on Government securities dealers, but there are none and there have been none, and we have had failures before and nothing has been done.

The recent failure in Florida of ESM clearly indicates that this is a national problem and that Federal legislation is absolutely necessary. I don't know how many more scandals and failures we're going to have to have before somebody does something.

Now we worked hard last week, Mr. Chairman, you and I, to restore the COLA's to the senior citizens of the United States who are on Social Security. And I'd like to tell you those same senior citizens take that little bit of income that they have and put a little bit away. This generation of senior citizens are absolutely fantastic when it comes to managing their own books. The outside impact really is getting to them but to this moment they are writing and calling and saying, "I don't want food stamps. I don't want Federal assistance. I just want to get by with the little bit I planned on and I always save a little bit of money."

A lot of these people invested in ESM and you might say buyer beware; they are unsophisticated. Well, who else got took besides my senior citizens and those in my State that are frugal enough to plan well enough that they can save a little bit? School districts, supposed to have high-priced consultants to tell them where to put their money; cities, municipalities lost a lot. Financial institutions that were shopping to make a better return on their investment lost a lot. And I think that is unacceptable because then the citizens lose twice. They lose the city's money; they lose the school district's money, and they lose their own little bit of investment that was supposed to tide them over, and many of them tell me their only failure in life is living too long. Their lives are longer than they planned on living and they would like to take care of themselves.

BETTER COMMUNICATION

One of the things I think we can do to correct the problem is having better communications between the State and the Federal Government. The State points to the Feds and the Feds point to the State and everybody is finger pointing and nobody is talking. Nobody is sitting down and saying whose fault it is and saying let's not have this ever happen again.

I read with interest what—I'll get his quotation—in a recent hearing before a House subcommittee when asked if more statutory power for the SEC would have prevented the ESM failure, John Shad, who's Chairman of the SEC, answered he believed that the SEC surveillance probably would have ventilated this situation. Is that a regulatory term in banking—ventilated?

I want something that will prevent this from happening and I really feel that I should tell my colleagues on this side of the body that it's a deep responsibility. I have introduced legislation. Other members of this committee have introduced legislation and it's now in our hands and I think that we have a deep responsibility if we do nothing else, in addition to your oversight and review which is probably the most important thing this committee does—I know a lot of creative things we could do, but oversight and review in my opinion are probably the best thing legislators can do. But we must consider including registration requirements, licensing employees, and subjecting dealers to adequacy standards. Those are three things I'm asking for and I would like to close in thanking my personal Congressman, Bill McCollum, for being here today, having such an active interest in this. He's a very bright young Congressman who represents the beautiful city of Orlando and Seminole County and I'd like to welcome you here and tell everyone here how much we think of you as a young Congressman who represents our district very, very well. Thank you for being here today.

Thank you, Mr. Chairman, for your interest in this.

Senator D'AMATO. Thank you, Senator.

Congressman McCollum, we echo Senator Hawkins' sentiments and we welcome you here and we're appreciative of the work you have put into this whole area.

STATEMENT OF BILL McCOLLUM, U.S. REPRESENTATIVE IN CONGRESS FROM THE STATE OF FLORIDA

Mr. McCollum. Mr. Chairman, I'm just delighted to be here and to be a part of this today and I'm pleased that you're holding this hearing and I have the utmost respect for Senator Hawkins as a person and as a Senator and I'm delighted she's my constituent. So it especially pleases me that today when I'm able to be before your committee that she is here as well testifying on the same subject.

I would like to submit my formal statement for the record and then just talk for a few minutes about it if I may, Mr. Chairman.

Senator D'Amato. It will be entered in the record in its entirety.

Mr. McCollum. As the chairman knows and I think the members of the panel know, I have offered legislation in the House, H.R. 1896, dealing with the subject of regulation of Government securities dealers.

This legislation comes because of the work that I have done as a member and ranking Republican member on the Subcommittee on Monetary Policy.

NEED FOR REGULATION APPARENT

The problems that Senator Hawkins described I think we all understand and I'm not going into them in detail today. I think the need for regulation should be apparent to anyone by now, by the failures that have occurred and are continuing to occur, and the need to protect the consumer and the public from the type of thing that has occurred.

But the question I think before us and before the committee should be, what form of regulation and who does the regulation?

The problems in this area seem to me to be narrowed to a couple of points. The less regulation that you have to have, the better. I think that's a general principle that most of us would agree on, regardless of what the area of regulation is.

This area demands some regulation, having none at the present time. The question beyond that is, what agency or group of agencies are best to do this regulation and the least of it?

In considering that, I would submit that there are three concerns that I have with any regulation and those concerns are that we maintain the efficiency of the marketplace for Government securities, that we maintain and not disrupt its liquidity, and that in the case of the Federal Reserve's ability to carry out monetary policy that we not disrupt that ability.

The Government securities area is the largest market in the world. The average volume I'm not sure of but I know at times the volume has been known to exceed $80 billion in a single day. A 10-basis point increase in the interest rate paid by the United States would result in increased costs to the taxpayers of over $2 billion a year. That is a 2-basis point increase in the cost of financing our debt. So I think that with that understanding—and I know the members of this committee certainly understand that—it is essential that whatever regulation is imposed on the securities dealers industry does not cost more to the taxpayers, does not disrupt the system as it currently exists in principle, and that the efficiency is maintained in that system.

The liquidity that I'm referring to is the ability to sell large amounts of Government securities regularly without disrupting the market. I was in New York recently with President Corrigan when our subcommittee in the House was there and I know from visiting one brokerage house the phenomenal amount of sales that go on and the fact that those sales could not take place if it weren't for the electronic abilities of our computer system today. In other words, 10 years ago the U.S. Government could not have had the kind of deficits and debt that we have to finance today because it would not have been possible for the dealers or for the system of finance to sell the debt in that size.

Senator D'AMATO. So maybe there's one of the shortcomings of efficiency that is the productivity of the computers.

Mr. McCOLLUM. That's right.

Senator D'AMATO. Otherwise we wouldn't have been able to finance the debt and maybe we wouldn't have incurred such a large debt.

Mr. McCOLLUM. If we didn't have this computerized age we might not have gotten to this point. But now that we're there, we can't afford to disrupt the system or it might collapse before your body and mine get to solving the problem of overspending and deficits which we obviously bear the responsibility for.

Senator D'AMATO. Now we have an added thing, Congressman. For a number of years I've heard Howard Baker lament that the worst thing that ever had to take place in the Senate was the air-conditioning, otherwise we wouldn't have been up to our mischief during the summers and the people would be better protected if we went back home. So now we say it's the age of the computer and air-conditioning.

Mr. McCOLLUM. I think it's an age of both and obviously we're working year round and I'm not sure that the public is better for our doing that. Obviously, the bigger the debt is, the more we need to work.

FINANCING THE HUGE DEBT

I would like to point out that this very point, that we have such a huge debt to finance, means that the system that now exists where the Fed goes to the auction market on behalf of our Government and the Treasury and everybody gets together and we sell this debt with regularity, requires that there be not only the 36 primary dealers that are out here now that are really consuming and are expecting to consume about 78 percent of all the purchasing that goes on directly when the debt is financed, when the paper and bills and bonds and notes are auctioned—we not only need those, but we really need these secondary dealers that are there in myriads of numbers which are the ones that are really unregulated.

On a regular basis the Federal Reserve Board and the Federal Reserve Bank in New York deal with these 36 primary dealers, but there is no direct dealing with the secondary dealers. That is where the primary dealers—the Merrill Lynches of the world and others—go out and actually allow the rest of the world to participate in the sale. They couldn't of course consume all of this themselves and in fact it is an international operation.

So in my judgment, whatever decision is made to regulate this market, we must preserve the network that exists of secondary dealers. We need to have that network available. We don't want to constrict the numbers and we don't want to reduce the activity.

The third and final consideration that I think is critical to determining what kind of regulation and who does the regulation is the question of the Federal Reserve's monetary policy, and that's intertwined with this because we go to the same marketplace to effectuate monetary policy through the Open Market Committee that we do to sell debt and it is the same marketplace that's needed in order for the monetary policy of the country to be carried out, which as we know is a very significant arm of economic policy of this country today. I think that it cannot be overlooked that stability and order needs to be maintained in any marketplace where we are dealing with the effectual beings of the policies of the Open Market Committee, an important consideration sometimes overlooked.

The most remarkable feature of all this is the fact that we don't have regulation at all. My bill, H.R. 1896, would give the regulatory authority to the Federal Reserve Board to make the regulations necessary of Government securities dealers, no matter who they are, primary or secondary.

I know there has been discussion of the Securities and Exchange Commission having certain authorities in this area—the registration that Senator Hawkins just mentioned and so forth. It seems to me it would be possible to have both bodies to have regulatory authority but, after reflecting on this for some time, it would be preferable to only have one single agency conducting this regulation and it seems to me that the agency most logical for this process is the Federal Reserve Board.

The reasons I give for that are simply that the Federal Reserve is the most knowledgeable currently about Government securities and Government securities dealers since they obviously are dealing in it, it's our paper that they are selling regularly and they have a contact on a regular basis with the 36 primary dealers and already have some nonstatutory and nonenforceable but nonetheless existing guidelines for those dealers, and also I think the Federal Reserve Board as the regulator in this situation would give a sense of stability to the marketplace, a sense of confidence that's needed not only from the standpoint of selling our paper but from the standpoint of the general aura of conducting monetary policy which the bank is required to do to effectuate the Open Market Committee decisions.

So, in short—it seems to me that while we might not have been able to control any given particular dealership failure because obviously in those cases where it appears to be fraud, as in the *ESM* case, no amount of regulation might have gotten to it, but there are opportunities if we do this right to prevent some of this from happening in the future, to give confidence to the marketplace, and to allow an orderly market to continue to exist in this absolutely critical area.

In my judgment, if Congress would make one agency accountable and hold that agency to the fire for that purpose, it would be a far better place for the economy of the country and the logical single agency, if a single agency is chosen, is the Federal Reserve Board. If not a single agency, certainly the Federal Reserve Board ought to at least be granted the authority to regulate generally in conjunction with whatever authority is granted to any other body.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT
OF
BILL McCOLLUM
MEMBER OF CONGRESS, 5th DISTRICT, FLORIDA
RANKING MINORITY MEMBER
SUBCOMMITTEE ON DOMESTIC MONETARY POLICY
COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
U. S. HOUSE OF REPRESENTATIVES

MR. CHAIRMAN, MEMBERS OF THE SUBCOMMITTEE, AS THE AUTHOR OF LEGISLATION (HR 1896) PENDING IN THE HOUSE DEALING WITH THE GOVERNMENT SECURITIES DEALERS I AM PLEASED TO HAVE THE OPPORTUNITY TO TESTIFY BEFORE YOU TODAY ON THE SUBJECT OF GOVERNMENT SECURITY DEALERS AND THE RECENT EVENTS THAT HAVE OCCURRED IN THIS MARKET. THE FAILURES OF ESM GOVERNMENT SECURITIES OF FLORIDA AND BREVIL, BRESLER AND SCHULMAN ASSET MANAGEMENT OF NEW JERSEY ARE JUST THE LATEST IN A SERIES OF GOVERNMENT SECURITIES DEALER FAILURES OVER THE LAST SEVEN YEARS. THIS DISTURBING TREND NOT ONLY EFFECTS THE INVESTORS DOING BUSINESS WITH THESE DEALERS BUT ALSO THE ABILITY OF THE UNITED STATES TO CONTINUE TO FUND OUR PUBLIC DEBT.

AT PRESENT NO FEDERAL DEPARTMENT OR CONGRESSIONALLY CREATED AGENCY OR BODY HAS STATUTORY AUTHORITY TO REGULATE GOVERNMENT SECURITY DEALERS. AFTER EACH PREVIOUS FAILURE CONGRESS HAS INVESTIGATED THE NEED FOR REGULATION OF THIS MARKET; BUT EACH TIME IT HAS FAILED TO GRANT REGULATORY AUTHORITY. CERTAINLY THE TIME IS RIPE NOW TO INSTITUTE THE NECESSARY CHANGES. THE QUESTION IS WHO BEST TO GIVE THE REGULATORY POWER.

ANY REGULATION OF DEALERS MUST NOT DISRUPT THIS MARKET'S EFFICIENCY, ITS LIQUIDITY, OR THE FEDERAL RESERVES ABILITY TO CARRY OUT MONETARY POLICY. LET ME SPEAK BRIEFLY TO EACH OF THESE AREAS OF CONCERN.

GOVERNMENT SECURITIES MARKET IS THE LARGEST AND MOST EFFICIENT CAPITAL MARKET IN THE WORLD. THE DAILY VOLUME IS KNOWN TO SOMETIMES EXCEED 80 BILLION DOLLARS. NO EXACT VOLUME FIGURES ARE AVAILABLE BECAUSE THE MARKET HAS NO CENTRALIZED CLEARING HOUSE OR TRADING FLOOR. MAINTAINING THE EFFICIENCY OF THIS MARKET IS OF GREAT IMPORTANCE TO THE UNITED STATES. AT A TIME WHEN WE ARE EXPERIENCING THE LARGEST DEFICITS IN OUR HISTORY, AND THE GROWING PUBLIC DEBT IS QUICKLY APPROACHING THE TWO TRILLION DOLLAR LEVEL, WE MUST BE CAREFUL NOT TO EFFECT REGULATION THAT WILL GREATLY INCREASE THE COST OF OUR DEBT. A TEN BASIS POINT INCREASE IN THE INTEREST RATE PAID BY THE UNITED STATES WOULD RESULT IN AN INCREASED COST TO THE U.S. TAXPAYER OF OVER TWO BILLION DOLLARS A YEAR. ANY REGULATION OF GOVERNMENT SECURITIES DEALERS MUST BE CARRIED OUT IN A MANNER THAT IS LEAST LIKELY TO INCREASE THE COSTS OF FINANCING OUR DEBT.

LIQUIDITY IS THE ABILITY TO SELL LARGE AMOUNTS OF GOVERNMENT SECURITIES REGULARLY WITHOUT DISRUPTING THE MARKET. CLOSELY RELATED TO LIQUIDITY IS THE ABILITY OF DEALERS TO FINANCE THEIR PURCHASES AND INVENTORY. WHEN THE FEDERAL RESERVE BOARD SELLS NEW GOVERNMENT SECURITIES THE 36 SO CALLED PRIMARY DEALERS ARE EXPECTED TO PURCHASE THE MAJORITY OF THE SECURITIES AT THE AUCTION. ROUTINELY THE PRIMARY DEALERS PURCHASE 70 TO 80 PER CENT OF THE SECURITIES SOLD AT AN AUCTION. EACH PRIMARY DEALER MUST

PARTICIPATE HEAVILY IN ORDER TO BE A PART OF THIS PRIVILEGED GROUP. IN ORDER TO FUNCTION UNDER SUCH AN OPEN ENDED ARRANGEMENT, THE PRIMARY DEALERS MUST BE ABLE TO SELL QUICKLY AND/OR FINANCE THEIR INVENTORIES. THIS IS THE ROLE OF THE SECONDARY DEALER. THE SECONDARY DEALER ACTS AS A SALES FORCE AND A FINANCE AGENT FOR ALL THE PRIMARY DEALERS, THOUGH SOME LIKE MERRILL LYNCH THAT HAVE THEIR OWN NATION WIDE SALES FORCE ARE LESS DEPENDENT ON THE SECONDARY DEALERS. THE SECONDARY DEALERS WILL SELL SECURITIES TO INSTITUTIONS THAT DO NOT PURCHASE LARGE ENOUGH QUANTITIES FOR THE PRIMARY DEALERS TO DEAL WITH DIRECTLY. THE SECONDARY DEALERS ALSO CONTACT THE MUNICIPALITIES AND OTHER SOURCES OF CASH TO ARRANGE FINANCING, OR REPOS, FOR THEIR OWN POSITIONS OR TO OFFER THE FINANCING TO THE PRIMARY DEALERS. THERE ARE THOSE AMONG THE SECONDARY DEALERS WHO PRIMARILY SEEK OUT THESE REPOS, WHO ONLY OCCASIONALLY SELL SECURITIES AND NEVER TAKE A POSITION IN THE MARKET OR CARRY ANY INVENTORY. THIS IS THE FUNCTION OF THE SECONDARY DEALER AND WHY THIS ROLE MUST BE MAINTAINED; WITHOUT THEM THE ABILITY TO DISPOSE QUICKLY OF A LARGE AMOUNT OF SECURITIES WITHOUT DISRUPTING THE MARKET WILL BE LOST. AND IT IS THE SECONDARY DEALER GROUP THAT MOST NEEDS REGULATION, BUT REGULATIONS MUST NOT BE SUCH AS TO SIGNIFICANTLY DECREASE THE NUMBER OR ACTIVITY OF SECONDARY DEALERS LEST THE LIQUIDITY OF THE ENTIRE MARKET AND THE ABILITY TO FINANCE OUR DEBT BE IMPARED.

THE FINAL CONSIDERATION IN THE DEBATE OVER REGULATION IS THE IMPLICATION THAT ANY CHANGE WILL HAVE ON THE CARRYING OUT OF MONETARY POLICY. THROUGH THE OPEN MARKET OPERATION AT THE NEW

YORK FEDERAL RESERVE BANK, THE FED CARRIES OUT MONETARY POLICY . THE MAIN FUNCTION OF THE THIRTY-SIX PRIMARY DEALERS IS TO ACT AS THE CONTACT POINT BETWEEN THE FED AND THE MARKET. THE OPEN MARKET DESK, USING REPOS AND REVERSE REPOS, INJECTS AND WITHDRAWS FUNDS IN ORDER TO MEET THE MONETARY TARGETS. WHILE THERE ARE OTHER METHODS TO CHANGE THE MONEY SUPPLY, NONE HAS THE IMMEDIACY OR THE CERTAINTY OF EFFECT OF THE OPEN MARKET DESK OPERATIONS. WITHOUT THE NETWORK CREATED BY THE SECONDARY DEALERS AND WITHOUT PUBLIC CONFIDENCE IN THE GOVERNMENT SECURITIES MARKETING SYSTEM, THE OPEN MARKET ACTIVITIES OF THE FED COULD BE SERIOUSLY IMPAIRED.

THE MOST REMARKABLE FEATURE OF THE GOVERNMENT SECURITIES MARKET IS THE LACK OF STATUTORY AUTHORITY FOR ANY FEDERAL REGULATION OF THE ACTIVITIES OF THE DEALERS. FOLLOWING THE RECENT FAILURES OF ESM AND BBS, SEVERAL BILLS HAVE BEEN INTRODUCED TO REGULATE THIS MARKET. I HAVE INTRODUCED HR 1896 WHICH GIVES THE FEDERAL RESERVE BOARD THE AUTHORITY TO REGULATE THIS MARKET AND REQUIRES THE FED TO REPORT TO CONGRESS ANNUALLY ON THE STATE OF GOVERNMENT SECURITY DEALERS. THE FED'S KNOWLEDGE AND EXPERIENCE IN THIS MARKET MAKE IT THE LOGICAL PRIMARY REGULATOR. IT IS THE AGENCY MOST CAPABLE OF CARRYING OUT A CRITICAL REGULATORY ROLE IN THE GOVERNMENT SECURITIES MARKET WITH THE LEAST ADVERSE EFFECTS. IN FACT THE PRESENTS OF THE FEDERAL RESERVE BOARD AS REGULATOR OF THE DEALERS WILL ADD CONFIDENCE AND STABILITY TO THE MARKET. REGULATION THROUGH ANY OTHER FEDERAL AGENCY IS LESS LOGICAL, UNNECESSARY AND POSES GREATER RISK OF DISRUPTING OR IMPAIRING THE MARKET.

COULD THE FED, OR ANY OTHER REGULATOR, HAVE PREVENTED THE COLLAPSE OF ESM OR BBS? WHEN FRAUD OCCURS THAT IS AS ALL ENCOMPASSING AS IT APPEARS TO BE IN THE ESM CASE IT WOULD BE HARD TO BELIEVE ANY AMOUNT OF REGULATION AND OVERSIGHT COULD HAVE PREVENTED ITS COLLAPSE. BUT WE MAY HAVE SEEN THE PROBLEMS AT ESM AND BBS EARLIER AND STOPPED THESE ACTIVITIES PRIOR TO THEIR COLLAPSE WITH THE WIDE SPREAD RAMIFICATIONS OR GOVERNMENT AUDITS MAY HAVE GIVEN SOME LOCAL GOVERNMENT INVESTORS REASON TO THINK TWICE BEFORE COMMITTING PUBLIC MONEY TO ESM OR BBS.

GOVERNMENT SECURITIES DEALERS NEED TO BE REGULATED . ONE AGENCY NEEDS TO BE GIVEN STATUTORY AUTHORITY TO DO THIS REGULATION AND THEN THAT AGENCY CAN BE HELD ACCOUNTABLE TO CONGRESS. AFTER YOU FINISH YOUR HEARINGS AND REVIEW OF THIS MATTER I AM CONFIDENT YOU WILL AGREE WITH ME THAT THE LOGICAL AGENCY TO BE GIVEN THIS AUTHORITY IS THE FEDERAL RESERVE BOARD.

THANK YOU FOR ALLOWING ME TO VOICE MY CONCERN AND VIEWS BEFORE YOU TODAY. MR. CHAIRMAN, I WOULD BE HAPPY TO ANSWER ANY QUESTIONS THAT YOU OR THE OTHER MEMBERS OF THE SUBCOMMITTEE HAVE.

Senator D'AMATO. Thank you very much, Congressman.

Let me ask you this, in essence hasn't the Fed been kind of a voluntary regulator at this point in time?

FED'S INFLUENCE ON DEALERS

Mr. MCCOLLUM. Yes, it has, but it's been a voluntary regulator of the 36 primary dealers. It really has only an indirect and very poor, in my judgment, regulatory impact on any of the secondary dealers, and there are hundreds of those out there.

Senator D'AMATO. Let's take it a step further. If we recognize the power that the Fed really does have, even without it having additional statutory authority, couldn't it and shouldn't it have been more aware of the deficiencies and have demanded more from the primary dealers?

Mr. MCCOLLUM. Well, I think you're going to get a chance to hear from President Corrigan on this later, but from my observations—and I have been through the hearing process on this already to some extent—it's my judgment that the Fed was in the process of doing a good deal of enforcement through the nonstatutory function that it had. It had already called for capital adequacy in its primary dealers and it was discussing the prospects of having them require capital adequacy in the secondary dealers when all this erupted in the last few months. Maybe we can second-guess them and say they should have been out in front sooner. Maybe somebody should have been asking for authority that they statutorily didn't have, but I will say this if I might, the concerns that have been expressed to me and have held back regulation in the past have been the fear of disrupting this market and it's the reason why I am urging that the Federal Reserve be given the statutory authority to put out regulations.

Senator D'AMATO. Let me take it a step further. Supposing I was to suggest or someone was to suggest that they really didn't need additional statutory authority to do a better job and to avoid this, that they really have the power, that they have done it innumerable times. If the Fed wants somebody to do something, even if they don't have that authority, believe me, they do it. I see Mr. Corrigan smiling, but it's a fact. They can cut you off at the knees 17 different ways and I have heard people complain when they think they have abused that authority say, "Well, what statutory authority do I have?" And I say, "Take them to court." And they say, "Senator, do you really mean that? We would be out of business by tomorrow." Maybe that's an overstatement.

What I'm suggesting—of course, never criticize the Fed. All right. I don't know why. I think they have done terrible jobs and terrible things over a period of time. They have done some good things. When the economy is good we all say what a wonderful job they're doing. But haven't they been remiss? And I'm not coming down on you. I'm going to ask Mr. Corrigan the same thing. This isn't 6 months that this problem has been in existence. It's not 1 year. It's not 2 years. There's a history, a litany of these things. I'm saying why didn't they use their authority? Why didn't they come to us? Why didn't they say, "We see a problem here and we need some more statutory authority or we need the SEC or we need to have an expanded rulemaking body."

What I'm really saying is I think they have been inefficient here. They have closed their eyes. This business of liquidity is absolutely important and we don't want to disrupt the markets and we don't want to drive up the cost, but I think as a practical matter that they have not done their job. And now, should we say we're going to give them the authority to do it? They had the 36 primary dealers. They are the people who could have said to the dealer, "This is what we want from you in terms of capital and in terms of the people that you deal with," but they haven't done it.

And I have not taken any position as to which way we should go because I share your concerns and I commend you on the job you have done, but I think I would be remiss if I didn't say—and this is an oversight hearing—that I'm not particularly thrilled with the job that the Fed has done.

Mr. McCollum. Well, Mr. Chairman, I can respect the judgment call that the Fed had to make. It's a difficult judgment call. I agree with you that there are undoubtedly in hindsight has to be some laxity there in our judgment of them. At the same time, though, I think it's true—and you will get that from them and I believe it—that getting to the secondary dealers is not that easy, even though they have all this power. There needs to be an auditing power for the secondary dealers. I don't think voluntary compliance is sufficient based upon what we have seen of these failures. There are some pretty gross situations that don't look to me like too much in the way of voluntary compliance is going to net you much.

We might have seen the Fed, for example, by indirection the audits that were done on ESM into their hands, but then what would they have had? They wouldn't have had their own audit. They would have an audit that was apparently jimmied.

We need to have the authority for the Fed or somebody to go in and actually regularly audit secondary dealers when they want to and they need statutory powers to do that. So what I'm saying to the chairman is, while I agree there was no crying of wolf soon enough, we would probably have been better served to have had it earlier and so on, and there was a judgment involved in it. I'm not here to judge the Fed on that question.

Whatever the case may be, we need statutory authority now to an agency, it seems to me, that despite its imperfections, the Fed is the most logical one to have that authority.

Senator D'Amato. Thank you very much, Congressman.

Senator Sasser.

Senator Sasser. No questions, Mr. Chairman. I have a statement which I would like to insert in the record in total as if read.

Senator D'Amato. So ordered.

OPENING STATEMENT OF SENATOR SASSER

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Senator Sasser. Thank you, Mr. Chairman.

We have a very complex set of issues here before us this morning. The string of failures in the Government securities market has focussed public attention on the risks associated with this high-speed multibillion dollar market. The response from the Federal

Government—from the regulators and from the Congress—must be swift and sure. We literally cannot afford further erosion of public confidence in the Government securities market. Failures such as Drysdale, Lion Capital, ESM, and Bevill-Bresler send shock waves not only through the financial community, but also through the public perception of the overall soundness of our Nation's financial institutions. One has only to recall the events in Ohio to make that point emphatically clear.

At the same time, a measure of caution on our part is in order. The daily operations of the Federal Government depend in great measure on the functioning of the Government securities market. The financing of the deficit and the conduct of monetary policy depend on this market's capacity to absorb and trade in Government debt. As we seek to improve the reliability of the participants in the market, I believe particular care should be exercised in considering any actions which could seriously impede the efficiency or liquidity of the market itself.

Nonetheless, it is clearly unacceptable simply to leave matters as they are. Deregulation of financial markets, the rapid development of instantaneous computer communications, and the accelerated pressure on funds managers to pursue more, and more diverse, investment options, have led to a situation that is conducive to irresponsibility and fraud. Investors trusting in the risk-free nature of the obligations of the U.S. Government have seen that trust abused by those who introduced hidden risks into the marketplace.

I know this morning's witnesses will have a great deal to contribute to the subcommittee's deliberations on this matter. I look forward to their testimony and to working with them and with my colleagues here on the development of an appropriate and effective response to the serious problems we face.

Senator D'Amato. Congressman, let me thank you for, No. 1, your testimony; and second, for taking the road of actually introducing some legislation which I wouldn't be a bit surprised that will be one of the vehicles that may be used by this committee as at least a starting off point.

Mr. McCollum. Thank you very much for the opportunity to come testify before your committee, Mr. Chairman. I appreciate how much you're doing on this.

Senator D'Amato. Thank you.

We have as our next witness, Gerald Corrigan, President of the Federal Reserve Bank of New York. Mr. President, how are you?

STATEMENT OF E. GERALD CORRIGAN, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. Corrigan. Good morning, Senator. If I may, I'd like to begin by asking that my statement be accepted into the record but I would like to summarize parts of it.

Senator D'Amato. Certainly. The record will reflect that the statement will be accepted in its entirety.

Mr. Corrigan. Mr. Chairman, I appreciate this opportunity to appear before this subcommittee to offer my views and to respond to your questions concerning recent problems in the Government securities market. While the circumstances and frequency of these problems—some involving specific allegations of fraudulent activities which I would consider to be outrageous—are clearly disturbing, the market as a whole continues to function effectively. Yet, the cumulative weight of recent disturbances does raise important questions about the structure and functioning of the market.

STRUCTURE OF THE SECURITIES MARKET

Let me start then by saying a few words about the structure of the market. As has already been said this morning, the market for Government securities is the largest, most efficient and most important securities market in the country and indeed in the world. The market consists of several broad categories of participants starting, of course, with the U.S. Government itself as the issuer of securities through its fiscal agents, the 12 Federal Reserve banks. In addition, the Federal Reserve Bank of New York, acting on behalf of the Federal Open Market Committee, uses day-to-day purchases and sales of Government securities as the primary instrument for the conduct of monetary policy.

Private participants in the market start with the so-called primary dealers. Firms are designated as primary dealers by the New York Fed based on a number of criteria which are contained in an appendix to my statement; 10 years ago there were 25 primary dealers. This number has grown to the present level of 36, 15 of which are banks or bank subsidiaries, 11 are broker-dealers subject to SEC regulation, and 10 are otherwise unregulated at the Federal level. The primary dealers are the core group of market makers for Government debt in that they maintain two-way markets for Government securities, and participate directly and actively in auctions of new Government debt. They serve, as Congressman McCollum indicated, as the essential bridge between the Treasury and the vast domestic and international network of institutions and individuals who are the ultimate holders of Government debt.

In addition to the primary dealers, there are a large number of bank and nonbank secondary dealers in Government securities. While the exact number of such secondary dealers is not known—in part because there is no consensus definition of a dealer and in part because a number of these dealers are not registered with any Federal agency—published and other sources would suggest there may be as many as 400 to 500 such firms. We believe that the majority of these secondary dealers are regulated in the sense that their Government securities dealer operations probably take place within an otherwise regulated banking organization or within an SEC registered broker-dealer. However, even with some of these regulated firms, the Government securities activities may, in fact, take place in an affiliate or subsidiary which is not subject to Federal regulation. In addition, perhaps 100 or more Government securities dealers are wholly unregulated at the Federal level.

These estimates of the number of secondary dealers are based largely on published and other reports of firms which label themselves as dealers. They, in turn, may have multiple subsidiaries or affiliates. There are also other major market participants, such as pension funds and large nonfinancial corporations, which by some definitions could qualify as Government securities dealers. Thus, the number of firms active in the market is large and would be still larger if the population were defined to include those firms and their affiliates that specialize in dealing in Government-backed or agency securities. Indeed, because that market includes a wide range of instruments and issuers, some of which are backed by the full faith and credit of the U.S. Government and some of which are not, additional questions and issues arise in this area as well.

Insofar as the role of the Federal Reserve Bank of New York is concerned, let me just summarize, Mr. Chairman, by saying that the Fed's initial interest in the safe functioning of the Government securities market is one that grew out of the time-honored tradition of knowing those with whom you do business. In this case, the primary dealers, since they are the only ones that we actually trade with. Over time, that interest took on some of the trappings of a more generalized but still voluntary system of oversight aimed at the primary dealers. The Fed has no statutory authority of an explicit nature in this area. That system of general surveillance over the primary dealers has, in my judgment, served the Treasury, the Fed, and the public well for a long period of time.

More recently, and reflecting in part changes in market structure, the Fed stepped up its efforts to learn more about the activities of some of the larger secondary dealers. That effort, also entirely voluntary in nature, entailed a very limited form of voluntary monthly reporting and efforts aimed at establishing voluntary capital adequacy standards.

The current arrangements, especially as extended to the secondary dealers, may not be adequate for the future. For example, by having an informal monitoring role, we may create an appearance of providing much greater protection from abuse than is justified. Moreover, given our present role, we have to be careful—indeed, very careful—in dealing with suspected problems—indeed, there may be circumstances where efforts to move in on a situation could create difficulty where none existed, or could make a large problem out of a small one. Some danger of this type probably exists with any regulatory scheme, but it is especially acute in the case of the Government securities market, given the intricate interdependence of that market with so many other parts of our financial structure and system. Since there can never be a fail-safe system of surveillance or even of regulation, I believe that recognition of these problems must be central to our thinking as we seek ways to guard against abuses while at the same time seek to preserve the strength and dynamism of the market.

RECENT PROBLEM SITUATIONS

Now in considering the question of the appropriate public policy response to the recent problem situations we have seen, it might be useful for the committee if I were to seek to identify some common characteristics associated with various episodes—recognizing, of course—and I want to stress this—that each individual situation has its own distinct traits. Indeed, because of those unique traits, it is risky to attempt generalization since each generalization will have its own exceptions. Yet, with that qualification firmly in mind, a close inspection of recent problem situations does suggest at least to me some important areas of commonality we should bear in mind on the question of public policy response.

The first, misleading financial statements. In a number of episodes, the firm in question had issued apparently false and/or misleading financial statements, some of which were audited and some of which were not. More specifically, it would appear that some individual cases entail allegations of outright fraud of a nature that can only be described as outrageous.

Second, multiple affiliated companies. In several instances, problems in one company were masked by relationships, and at times complex transactions, with affiliated companies. Indeed, in some instances it would appear that some investors may not have fully understood which entity or chain of entities was the counterparty to their particular transactions.

Third, the use of working capital generated by so-called matched-book operations. In the jargon of the trade, a matched book is the holding by a dealer of an equal and offsetting—or matched—amount of reverse repurchase agreements and repurchase agreements. Matched-book operations are central to the workings of the market because they provide a convenient vehicle for dealers to serve as efficient intermediaries between those seeking to invest in Government securities and those seeking to use holdings of Government securities to gain liquidity. In theory, a matched-book operation—even one of considerable size—should be a very low-risk activity to the dealer and to its customers. In practice, however, the theory may not always apply. For example, if the amount of the book is matched, but not the maturities, the overall position can include somewhat greater risk.

Moreover, and more importantly for these purposes, a matched book, by its very nature, can produce working capital for the dealer through the excess margin that can be produced during the term of certain RP transactions. In a number of the problem situations it now appears that the dealers in question used working capital generated by matched-book operations to engage in trading for their own account and in the process incurred losses and/or attempted to use such working capital to make up losses.

Fourth, improper control arrangements. In a number of instances, customers of problem dealers incurred losses because the customers failed both to know their counterparty and to secure control of the securities underlying the RP transaction with the problem dealer. The failure to know the counterparty—its financial status and its management—and/or to secure control of the securities, whether caused by carelessness or misrepresentation or both, not only ultimately resulted in the loss to the customer but also had the effect of providing funds to the problem dealer, thereby permitting the dealer to continue operations in a way that may have disguised its true financial condition.

The last point I would mention is what I call the drive for earnings. In looking at the list of harmed customers of problem dealers it is easy to conclude that some, if not many, incurred losses because they were naive about the nature of the transactions. In a proximate sense, that may be true. But, in a more fundamental sense, some of these customers may have been easy targets because they—out of pressures to generate interest income—were all too willing to be seduced by the prospect of a special deal. Unfortunately, for a struggling thrift or a cash-pressed municipality, these temptations can be great, especially when the transaction in question involves a risk-free Treasury security. The point, of course, is that the security may be risk-free while the transaction is quite risky.

As I mentioned earlier, these factors are not common to all problem situations, nor do they exhaust the possible list of causes or probable causes of the difficulties we have seen. For example, they do not include the accrued interest problem that was a key factor in one case, nor do they include any possible connections among individuals associated with one or more of the problem dealers, nor the possible role that money brokers may have played in one or more cases. What they do suggest, however, is that the problems we have seen are multifaceted and entail factors ranging from investor attitudes and motivations on the one hand to gross misrepresentation and alleged wholesale fraud on the other, none of which is necessarily easy to eliminate by regulation.

Now clearly, recent events have brought into even sharper focus the question of whether part or all of the Government securities market should be subject to some form of regulation backed up by explicit statutory authority. Indeed, several bills have been introduced in the Senate or the House to that end. And many market participants and the Public Securities Association are now on record as favoring some form of regulation. All of this, in my judgment, is fully understandable since the cumulative effect of the recent string of failures of Government securities has been, to put it mildly, unsettling.

CAUTIOUS APPROACH ON REGULATIONS

Yet, as we seek a higher level of assurance that the problems of the past will not be repeated, we must proceed with caution. In the case of the Government securities market, the costs of poorly conceived or poorly executed regulation could be enormous and I think it should also be pointed out that the possible uncertainties and instabilities growing out of further problems could also have an even greater impact.

Reflecting these considerations the Fed, the Treasury, and the SEC are working diligently to arrive at a position on whether legislation is needed and, if so, what form such legislation should take. The interagency position is expected to be communicated to the Congress no later than mid-June. Those interagency deliberations are, in the first instance, aimed at further fact finding and, in the second, at a review of various alternative approaches to regulation of the Government securities market. A key date in that process will be May 20, the deadline for the submission of responses to the SEC's request for public comment on the oversight of the Government securities market.

In tandem with the interagency review, we at the New York Fed are moving ahead on several fronts including: One, the implementation of the system of voluntary capital guidelines aimed largely at the unregulated secondary dealer community; two, an expanded public education program targeted at certain classes of investors in

RP-type transactions; three, stepped up bank supervisory efforts regarding the involvement in RP-type transactions by depository institutions; and four, the expansion of the scope and intensity of our onsite inspection program for primary dealers. In this regard, I had also hoped that there might be some operational enhancements to the book-entry system for Government securities which might prove useful in improving controls surrounding RP-type transactions. However, based on our preliminary analysis, it is clear that any such major enhancements will not come quickly or cheaply, if at all.

In closing, Mr. Chairman, let me to stress four points. First, I share the deep concerns expressed in the Congress and elsewhere about the recent problems in the Government securities markets. Second, despite these problems, the market as a whole continues to function effectively in fair weather or foul. Third, the issues involved in the question of whether the Government securities market should be regulated and, if so, the appropriate form of such regulation are exceedingly complex. Finally, if it appears that regulation is required, we are challenged to do it in a way that introduces minimal inefficiences and costs into a market that is so vital to our overall financial and economic well being. We look forward to working closely with the Congress in seeking solutions to these difficult issues.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT OF
E. GERALD CORRIGAN
PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. Chairman, I appreciate this opportunity to appear before this Subcommittee to offer my views and to respond to your questions concerning recent problems in the U.S. government securities market. While the circumstances and frequency of these problems--some involving specific allegations of fraudulent activities which I would consider to be outrageous--are clearly disturbing, the market as a whole continues to function effectively. Yet, the cumulative weight of recent disturbances raises some important questions about the structure and functioning of the market. My prepared statement consists of four sections; the first outlines the structure of the government securities market; the next reviews the role of the Federal Reserve Bank of New York as it relates to the market; the third seeks to identify some common elements or traits in problem situations in the markets; and the last contains some thoughts regarding the future operation of the market.

I - The Structure of the Government Securities Market

The fact that the market for U.S. government securities is the largest, most efficient and most important securities market in the country and the world is well documented and need not be developed for this Subcommittee. The market consists of several broad categories of participants starting, of course, with the U.S. government itself as the issuer of the securities through its fiscal agents--the 12 Federal Reserve Banks. In addition, and as detailed in the following section, the Federal Reserve Bank of New York--acting on behalf of the Federal Open Market Committee--uses the day-to-day purchases and sales of government securities as the primary instrument for the conduct of monetary policy.

Private participants in the government securities market start with the so-called primary dealers in U.S. government securities. Firms are designated as primary dealers by the Federal Reserve Bank of New York based on a number of criteria. These criteria are detailed in the appendix to this statement. Ten years ago there were 25 primary dealers. This number has grown to the present level of 36--15 of which are banks or bank subsidiaries, 11 are broker/dealers subject to S.E.C. regulation and 10 are otherwise "unregulated" at the federal level. The primary dealers are the core group of market makers for government debt in that they maintain two-way markets for government securities, and participate directly and actively in auctions of new government debt. They serve as the essential bridge between the Treasury and the vast domestic and international network of institutions and individuals who are the ultimate holders of government debt.

In addition to the primary dealers, there are a large number of bank and non-bank "secondary" dealers in government securities. While the exact number of secondary dealers is not known--in part because there is no consensus definition of a dealer and in part because a number of these dealers are not registered with a Federal agency--published and other sources would suggest that there may be as many as 400 to 500 firms. We believe that the majority of these secondary dealers are "regulated" in the sense that their government securities dealer operations probably take place within an otherwise regulated banking organization or within an S.E.C. registered broker/dealer. However, even with some of these "regulated" firms, the government securities activities may, in fact, take place in an affiliate or subsidiary which is not subject to federal regulation. In addition, perhaps 100 or more government securities dealers are wholly unregulated--at least at the federal level.

These estimates of the number of secondary dealers are based largely on published and other reports of firms which label themselves as dealers. They, in turn, may have multiple subsidiaries or affiliates. There also are many other major market participants such as pension funds and large non-financial corporations which, by some definitions, could qualify as government securities dealers. Thus, the number of firms active in the government securities market is large and would be still larger if the population were defined to include the firms--and their affiliates--that specialize in dealing in government-backed or agency securities. Indeed, because the "agency" security market includes a wide range of instruments and issuers--some of which are backed by the full faith and credit of the U.S. government and some of which are not--additional questions and issues may arise in this area.

II - The Role of The Federal Reserve Bank of New York

The Federal Reserve Bank of New York's direct interest in the operation of the government securities market grows out of the fact that day-to-day purchases and sales of government securities are the primary vehicle used by the Fed in seeking to influence the growth of money and credit. During 1984, for example, the aggregate value of such transactions conducted by the Fed with the primary dealers was $209 billion. The Fed also acts on behalf of approximately 150 foreign central banks and other foreign official institutions in the market. Transactions conducted by the Fed on behalf of these institutions in 1984 amounted to $211 billion. All Fed transactions in government securities--whether for its own account or for the account of foreign official institutions--are conducted only with the primary dealers.

The origins of the Federal Reserve Bank of New York's role in providing a form of surveillance over the primary dealers were, in part, a straightforward business proposition. Given the enormous volume of public funds associated with the Fed's transactions in the marketplace, it was quite natural that in conducting these transactions the New York Fed would be guided by one of the oldest precepts in trading--"know your counterparty."

Of course, our interest in the workings of the market goes beyond our strict business relationships with the primary dealers. Indeed, our concern stems from the fact that the government securities market is the market which we use for monetary policy implementation and which the Treasury uses for financing the federal government. Over time, and in recognition of the larger public interest considerations associated with the operation of the government market, the New York Fed's role in the market evolved into an informal watch-dog function which loosely incorporated some elements of traditional regulatory functions.

This evolution of the Fed's interest in the government securities market took place, however, in a framework in which the Fed had and continues to have no express statutory authority.. At the same time, the sheer growth of the debt as well as advances in communications and technology have made it possible for hundreds of new firms to enter the government securities business and operate nationwide from virtually any location in the country.

To summarize, the Fed's initial interest in the safe functioning of the government securities market was one that grew out of the time-honored tradition of knowing those with whom you do business. Over time, that interest gradually took on some of the trappings of a more generalized but essentially voluntary system of oversight aimed at the primary dealers. That system of general surveillance over the primary dealers has, in my judgment, served the Treasury, the Fed and the public well for a long period of time.

More recently, and reflecting in part changes in market structure, the Fed stepped up its efforts to learn more about the activities of some of the larger secondary dealers in government securities. This effort--also entirely voluntary in nature--entailed a very limited form of voluntary monthly reporting and efforts aimed at establishing voluntary capital adequacy standards.

The current arrangements, especially as extended to the secondary dealers, may not be adequate for the future. For example, by having an informal monitoring role, we may create an appearance of providing much greater protection from abuse than is justified. Moreover, given our present role, we have to be careful in dealing with suspected problems--indeed there may be circumstances where efforts to move in on a situation could create difficulty where none existed, or could make a large problem out of a small one. Some danger of this type probably exists with any regulatory function, but it may be especially acute in the case of the government securities market, given the intricate interdependence of that market with so many other parts of the financial structure. Since there can never be a fail-safe system of surveillance or even of regulation, I believe that recognition of these problems must be central to our thinking as we seek ways to guard against abuses while at the same time seek to preserve the strength and dynamism of the market.

III- Recent Problem Situations

In considering the appropriate public policy response to the recent problem situations involving government securities dealers, it is useful to seek to identify some common characteristics associated with various episodes--

recognizing, of course, that each situation has had its own distinct traits. Indeed, because of the unique traits of each case, it is risky to attempt generalization since each generalization will have its exceptions. Yet, with this qualification firmly in mind, a close inspection of recent problem situations does suggest several areas of commonality. Among these are the following:

1. Misleading Financial Statements: In a number of episodes, the firm in question had issued apparently false and/or misleading financial statements, some of which were "audited" and some of which were not. More specifically, it would appear that some individual cases entail allegations of outright fraud of a nature that can only be described as outrageous.

2. Multiple Affiliated Companies: In several instances, problems in one company were masked by relationships, and at times complex transactions, with affiliated companies. Indeed, in some instances it would appear that some investors may not have fully understood which entity was the counterparty to transactions.

3. The use of working capital generated by matched-book operations: In the jargon of the trade, a matched book is the holding by a dealer of an equal and offsetting--or "matched"--amount of reverse repurchase agreements and repurchase agreements. Matched-book operations are central to the workings of the market because they provide a convenient vehicle for dealers to serve as efficient intermediaries between those seeking to invest in government securities and those seeking to use holdings of government securities to gain liquidity. In theory, a matched-book operation--even one of considerable size--should be a very low-risk activity to the dealer and to its customers. In practice, however, theory may not always apply. For example, if the amount of the book is "matched," but not the maturities, the overall position can include somewhat greater risk.

Moreover, and more importantly for these purposes, a matched book, by its very nature, can produce working capital for the dealer through the excess margin that can be produced during the term of certain RP transactions. In a number of the problem situations it appears that the dealers in question used working capital generated by matched-book operations to engage in trading for their own account and in the process incurred losses and/or attempted to use such working capital to make up losses.

4. Improper Control Arrangements: In a number of instances, customers of problem dealers incurred losses because the customers failed both to know their counterparty and to secure control of the securities underlying the RP transaction with the problem dealer. The failure to know the counterparty--its financial status and its management--and/or to secure control of the securities--whether caused by carelessness or misrepresentation or both--not only ultimately resulted in

the loss to the customer but also had the effect of providing funds to the problem dealer, thereby permitting the dealer to continue operations in a way that may have disguised its true financial condition.

5. The Drive for Earnings: In looking at the list of harmed customers of problem dealers it is easy to conclude that some, if not many, incurred losses because they were naive about the nature of the transactions. In a proximate sense, that conclusion may be warranted. But, in a more fundamental sense, some of these customers may have been easy targets because they--out of pressures to generate interest income--were all too willing to be seduced by the prospect of a "special deal." Unfortunately, for a struggling thrift institution or a cash-pressed municipality, these temptations can be great, especially when the transaction in question involves a "risk free" Treasury security. The point, of course, is that the security may be risk-free while the transaction can be quite risky.

As mentioned earlier, these factors are not common to all problem situations we have seen in the government securities market nor do they exhaust the possible list of causes or probable causes of the difficulties that have occurred. For example, they do not include the accrued interest problem that was a key factor in one case, nor do they include any possible connections among individuals associated with one or more of the problem dealers, nor the possible role that "money brokers" may have played in one or more cases. What they do suggest, however, is that the problems we have seen are multifaceted and entail factors ranging from investor attitudes and motivations on the one hand to gross misrepresentation and alleged wholesale fraud on the other, none of which is necessarily easy to eliminate by regulation.

IV - Looking to the future

Recent events have brought into even sharper focus the question whether part or all of the government securities market should be subject to some form of formal regulation backed up by explicit statutory authority. Indeed, several bills have been introduced in the Senate or House to that end. Moreover, many market participants and the Public Securities Association are now on record as favoring some form of regulation. All of this is understandable since the cumulative effect of the recent string of failures of government securities dealers has been, to put it mildly, unsettling.

Yet, as we seek a higher level of assurance that the problems of the past will not be repeated, we must proceed with caution. In the case of the government securities market, the costs of poorly conceived or poorly executed regulation could be enormous. For example, if regulation unnecessarily affected the liquidity and efficiency of the market in an adverse way to the extent of raising the average yield on Treasury securities outstanding by only 10 basis points, the cost to the Treasury and ultimately to the taxpayer would mount to a staggering $1.7 billion per annum at current levels of Treasury debt. On the other hand it is, of course, possible that uncertainties and instabilities growing out of further problems could have an even greater market impact.

Reflecting these considerations the Fed, the Treasury, and the S.E.C. are working diligently to arrive at a position on whether legislation is needed and, if so, what form such legislation should take. The inter-agency position is expected to be communicated to the Congress no later than mid-June. Those inter-agency deliberations are, in the first instance, aimed at further fact finding and, in the second, at a review of various alternative approaches to regulation of the government securities market. A key date in that process will be May 20, the deadline for the submission of responses to the S.E.C.'s request for public comment on the oversight of the government securities market.

In tandem with the inter-agency review, we at the Federal Reserve Bank of New York are moving ahead on several fronts including; (1) the implementation of the system of voluntary capital guidelines aimed largely at the "unregulated" secondary dealer community; (2) an expanded public education program targeted at certain classes of investors in RP-type transactions; (3) stepped-up bank supervisory efforts regarding the involvement in RP-type transactions by depository institutions; and (4) the expansion of the scope and intensity of our on-site inspection program for primary dealers. In this regard, I had also hoped that there might be some operational enhancements to the book-entry system for government securities which might prove useful in improving controls surrounding RP-type transactions. However, based on our preliminary analysis, it is clear that any such major enhancements will not come quickly or cheaply, if at all.

In closing, Mr. Chairman, allow me to stress four points. First, I share the deep concerns expressed in the Congress and elsewhere about the recent problems in the government securities markets. Second, despite these problems, the market as a whole continues to function effectively in fair weather or foul. Third, the issues involved in the question of whether the government securities market should be regulated and if so the appropriate form of such regulation are exceedingly complex. Finally, if it appears that regulation is required, we are challenged to do it in a way that introduces minimal inefficiencies and costs into a market that is so vital to our overall financial and economic well being. We look forward to working closely with the Congress in seeking solutions to these difficult issues.

APPENDIX

Primary Dealers

This appendix outlines the standards that the Federal Reserve uses in deciding to add a dealer in U.S. government securities to the list of daily reporting "primary dealers." Several factors go into this determination, including volume of market-making activity, financial strength of the firm, depth and experience of management, and evidence of commitment of management to continue participating as a market-maker.

Some of these criteria are more readily and objectively measured than others. To measure volume of market-making activity, we receive reports for a number of months from firms seeking to be added to the primary dealer list. We compare the dealer's volume of purchase-and-sale activity in various sections of the market to that of other dealers currently on the list. We pay particular attention to the volume of trading activity with "customers"--i.e., activity excluding trading with other primary dealers. In the past our minimum standard for a new primary dealer was that such a firm should show customer activity for a sustained period equal to at least one percent of the total of all existing primary dealers. More recently, we have modified that criterion somewhat in order to avoid making the entry barrier too high. As the number of primary reporting dealers increased from 25 or so a decade ago, to about 35-37 in recent years, it became more difficult to reach and maintain a one percent level. Accordingly, our current approach is to compare the volume or activity of a prospective addition to the list to that of several of the smaller dealers currently on the list whose volume is considered adequate.

In addition to overall activity with customers, we look for a degree of diversity in securities and maturity areas covered, as well as a reasonable diversity of the customer base. (A firm that traded almost entirely with a very small group of customers would not be considered a true "market-maker.") In addition to our standard for secondary market-making, we expect a primary dealer to be a consistent and meaningful participant in Treasury auctions of new securities. We do not insist that a dealer take down a particular amount of securities from the Treasury, but we expect to see auction bids of a size commensurate with the dealer's capacity and in a realistic price range relative to current market conditions.

In looking at a prospective primary dealer's capital strength, we relate capital to the risk exposure of positions taken. We do not have a specific minimum level of capital in absolute terms, but it is hard to imagine that a viable market-maker would be able to function prudently with less than $10 or $15 million of capital; most of the primary dealers have substantially more than this. In evaluating financial soundness, we also take into account whether other regulatory frameworks apply to the firm--such as bank regulation, or S.E.C. regulation of registered broker-dealers in corporate or municipal securities. A history of audited financial statements is, of course, essential.

The experience and capacity of a firm and its key personnel are also considered in our decision. A primary dealer is expected to have experienced trading personnel, a seasoned sales staff, and operational capabilities to process and account for its transactions efficiently and accurately. Proper controls over all operations by management and auditing staffs are also essential. These aspects of the firm, among others, are reviewed in on-site inspection by members of the Federal Reserve's Dealer Surveillance Staff.

Senator D'AMATO. Thank you very much.

First of all, let me commend you for your presentation and your analysis. Let me ask you if in your opinion you believe that there's a need for additional regulation in this area.

Mr. CORRIGAN. I am not allergic to regulation. I am allergic to bad regulation.

Senator D'AMATO. OK.

Mr. CORRIGAN. I am truly impressed, Mr. Chairman, with the complexities of the questions that arise here in terms of how you build a better mousetrap. Again, I mentioned just as one example in my statement, this question of agency securities. I think there's a strong presumption just as a matter of logic that if you're going to regulate the Government market, that thrust would apply to the agency—mortgage-backed securities and so on.

Again, the vast differences in the way these markets operate on a minute-to-minute or hour-by-hour basis really does create some formidable problems. So again, I'm not allergic to the concept, but I am allergic to a hasty or an ill-conceived approach because I think that could be very, very costly.

Senator D'AMATO. Well, Mr. Corrigan, this is a Senator who has not introduced a piece of legislation on this and I didn't because rather than being accused of overreacting I wanted to give people an opportunity in the industry, the regulators, Chairman Shad here at our last hearing—we're going to have the Public Securities Association make known their thoughts, but I have to ask you this right on the record—what changes do you feel are necessary in the oversight and regulation of the Government securities market, if any?

In other words, you say, well, it's very complex and we don't want to do this, that and the other thing. That's not really answering the question. It's not being responsive.

SHOULD FOCUS ON FOUR OR FIVE KEY ELEMENTS

Mr. CORRIGAN. If the decision was made to proceed with legislation, I think there are perhaps four or five key elements that one should be focusing on.

Senator D'AMATO. Are you aware of the number of bills that have been introduced?

Mr. CORRIGAN. I certainly am.

Senator D'AMATO. Senator Cranston and others on this committee have introduced legislation, Congressman Wirth has introduced legislation. Really what I'm trying to say to you is, if the regulators themselves just stand back there and wring their hands and say we're concerned that it may go too far, it may be too costly, it may be ineffective and inefficient, and it's going to impede the liquidity of the marketplace and wind up costing the taxpayers too much. What you may be doing is singing that song over, and over, and over and then getting a piece of legislation that does exactly all the things you feared. So what I'm saying to you is, here you are. You have the problem. You have been dealing with it. You're beginning to undertake certain steps in order to correct the situation. All right. Can you tell me that you have it within your power to deal with all the problems?

Mr. CORRIGAN. I do not. I can assure you of that.

Senator D'AMATO. OK. Do you need some additional help in this area?

Mr. CORRIGAN. Again, let me go back to the thrust of your first question. I think there are three or four key elements that I think would have to be part of a regulatory effort based on statute if that was considered.

I think the ones that would be essential are: First, that you have registration at the Federal level. Now that, among other things, assumes you solve all these definition questions.

Second, I think that you should have the capacity to establish broad financial standards, capital adequacy standards, and corresponding authority to establish reporting requirements.

I think you also have to have the authority to do onsite inspections.

Senator D'AMATO. We are making progress.

Mr. CORRIGAN. And last, I think we have to have some kind of enforcement authority, cease and desist authority.

But I think those are the elements that strike me as being necessary ingredients.

Now the problem—and again, believe me, this is not procrastination—the problem is, OK, if those are the ingredients, how do you properly structure them to avoid heavy-handed, burdensome, inefficient regulation and how do you fit them within the context of some orderly overall administrative structure? I think those issues are equally as important as the substance of what it is you're trying to do. But those are the elements, Mr. Chairman, that I would consider essential to a regulatory approach if that was the direction in which we were to move.

Senator D'AMATO. All right. We're making some progress now. First of all, we are saying that they've got to be regulated.

Mr. CORRIGAN. I think you said that. I haven't quite said that.

Senator D'AMATO. Well, you said that there has to be registration, so we have to have some legislation for that.

Mr. CORRIGAN. I said, if you are going to have statutory authority, those are the five elements that I think are essential.

Senator D'AMATO. All right.

Mr. CORRIGAN. I still have at least a lingering question in my mind as to whether you absolutely have to go that route, but I'm not going to——

Senator D'AMATO. OK. Let's suppose we don't have to go that route. How are you going to accomplish these necessary standards? Are we saying, that which you just elucidated in terms of onsite inspection, in terms of registration, in terms of enforcement, in terms of reporting requirements—these are all things that you just testified to——

Mr. CORRIGAN. Again, that's one of the reasons, Mr. Chairman, I tried to put in my statement that litany of what really happened, what are the commonalities, because I think that provides a little bit of a litmus test. I think it should be stated, for example, that the single most dominant aspect of the problems that we have seen seems to be alleged fraud, and there are under existing laws and regulations remedies for fraud even in the case of a Government securities dealer that is not registered, and I think that distinction, as distasteful a distinction as it is, has to be borne in mind.

Senator D'AMATO. What you're saying is, regardless of what legislative initiatives that we implement, there are still those areas of out and out fraud which will always present a problem and will result sometimes in these fairly successful undertakings and in a loss of money to the public. We understand that.

Mr. CORRIGAN. And that there are——

Senator D'AMATO. Certain things you can't guard against?

Mr. CORRIGAN [continuing]. Existing remedies for that.

Senator D'AMATO. All right. Having said all of this, let's get down to the bottom line. If all of these things—registration, reporting requirements, onsite inspection—all of these things that you say are necessary—who is going to bring them about and under whose aegis should this take place?

Mr. CORRIGAN. Well, again, that is—I simply do not want to try and prejudge that in the face of these interagency deliberations that are going on. There are probably a dozen or more conceptions that one——

Senator D'AMATO. Well, let me tell you, if I introduced a bill and gave it all to the SEC, then maybe you would prejudge it.

Mr. CORRIGAN. No.

Senator D'AMATO. Maybe you would come forward then and you would have to make a comment. Then you would say, "Well, gee, Senator, here we are, we are undertaking these things and you have imposed another one and isn't that going to be costly, and so forth?" You know what I'm trying to say. Let's focus on the problem. Let's not go through an exercise and have one of these situations where we come to a markup and then have you come in here and tear the bill to shreds whether its you individually or somebody else. What I'm saying is I think you have a responsibility, being the person who's there and the agency dealing with it, who sees the problems and has the balance. We are looking for some suggestions from you. I'm putting it right on the line. What do you have to say as to how we build a better mousetrap to deal with as many of the problems as we possibly can. We recognize that you can't be 100 percent certain. Do you think there should be some legislative initiative? Well, if you don't, tell me. If you think that the Fed has adequate power to deal with this without any kind of congressional legislation, then say it. But you can't have it two ways.

Mr. CORRIGAN. I'm not trying to have it two ways.

Senator D'AMATO. Yes, you are. Yes, you are.

Mr. CORRIGAN. You're raising differences of opinion among the agencies, for example, which is precisely the reason why there is considerable value for this interagency process that's taking place to take place because I think the interest of the Congress and the public at large will be better served by a coordinated——

Senator D'AMATO. When are you coming forth with a report then? May 17?

Mr. CORRIGAN. As I said in my statement, the report will be made available to Congress in mid-June. The public comment period that is currently in place ends on May 20, I believe.

Senator D'AMATO. So what you're saying to me really, in essence, is failing the completion of that information, you are not willing to go any further in your suggestions as to how we build a better mousetrap.

Mr. CORRIGAN. Again, I think the thrust of what I have said——

Senator D'AMATO. So the record is more complete, how do we deal with this problem and whether we answer the question as to whether or not we need statutory authority and legislative initiatives to deal with whatever the deficiencies may be. Do you need additional legislative authority to deal with the situation in terms of secondary brokers and those brokers who don't come directly under your responsibility?

EXAMPLE OF PROBLEM SITUATIONS

Mr. CORRIGAN. Again, as I said in my statement, in my judgment, there are some clear problems there. We have had, just as an example, situations in which even where there was a recognized problem, where we have been unable to gain information and access in the case of one or more secondary dealers, they simply refused on advice of their counsel to permit us to visit them and try to get a hands-on sense of what was going on. And that, in my judgment, is clearly very problematic. Now in some cases the SEC through NASD or another instrumentality has access and I don't think, again in the interest of efficiency of the Government itself, we want to be building unnecessary elements of overlap into the structure.

But, yes, there are problems. I do not dispute that and I am not allergic to any solution that is an efficient, effective solution. But I am concerned, as I think you are too, with an ill-conceived and therefore ineffective solution that turns out not to be a solution.

Senator D'AMATO. Well, if I take all the outlines of what you've indicated in terms of the five considerations, I can prepare by this afternoon a stripped-down version giving you that authority in the Federal Reserve and saying here it is. I think I could get a bill passed.

Mr. CORRIGAN. Well, again, I would just urge, for what it's worth, that we permit this interagency deliberation, study and review to run its course. I would go one step further and say that if indeed the result of all that——

Senator D'AMATO. Is OMB going to take part in this interagency task force?

Mr. CORRIGAN. Pardon me?

Senator D'AMATO. Is OMB going to be part of this interagency task force?

Mr. CORRIGAN. I think in this case, Mr. Chairman, the nature of the interest on the part of the three agencies that I mentioned, at least in my judgment, is rather clear and unambiguous. I don't think it's a question of bureaucratic——

Senator D'AMATO. Will we have to get OMB to sign you off?

Mr. CORRIGAN. If you got into a statute or a regulation, for example, that required reporting, I think as a matter of procedure OMB has to sign off.

Senator D'AMATO. Let me tell you something, all your good work and good effort of that interagency task force, if you get it done by June, you'll be 2 years filibustering with them on anything, any law or regulation, so that nothing will be addressed on the inadequacies that presently exist. But that's my own comment. You don't have to comment on that. At least they can't cut your budget.

Senator Riegle.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you, Mr. Chairman. Mr. Chairman, as is usually the case, you're in fine form today and right out there moving things ahead and I appreciate the spirit with which you go after these subjects. It gets my blood running a little faster I must say.

I want to go through a line of discussion with you in some detail and, as a result, because I want to stay in a certain order, I will crisscross in passing some of the things that have been discussed but I want to deal with them in sequence here.

FAILURES SINCE 1977

Let me move along as quickly as I can. Since 1977, the following Government securities dealers failures have occurred: The Winters Government Securities Corp. in 1977; Drysdale in 1982, Lombard-Wall in 1982, Lionel Capital in 1984, and now ESM and Bevel-Bresler in 1985.

You have now had ample opportunity, I think, to review these specific failures and I have three questions I want to raise.

The first is this: What have you learned from these particular failures and how might they be prevented in the future?

Mr. CORRIGAN. Well, in terms of what we have learned, again, in the middle part of my testimony, Senator, I tried to categorize what struck me as the major common elements and again I have to emphasize, unfortunately, the dominant one is this allegedly fraudulent activity.

Senator RIEGLE. Could you pull the mike closer?

Mr. CORRIGAN. As I said, in terms of what we have learned, I think what I tried to do in the middle part of my statement was kind of spell out the common elements that seemed to me to suggest themselves and again I was emphasizing that, unfortunately, in that effort to look for those common denominators this pattern of alleged fraud kind of leaps out.

Senator RIEGLE. What in addition to fraud?

Mr. CORRIGAN. Well, as I said, I think that we see these patterns of failure on the part of market participants to secure control of their collateral. We've had the situation involving the misuse of working capital generated by certain types of these activities. We've had this general pattern where participants from many segments of the market kind of get bored by a special deal in the interest of trying to get that extra 10 or 20 basis points. And as I said, we've had these patterns of financial misrepresentation and those are the things that stick out, along with the allegations of fraudulent activities.

Senator RIEGLE. Well, it seems to me that those tend to fall under the category, if you will, of the buyer beware. In other words, if the person who is buying the security isn't prudent enough or somehow is misled or is too greedy or not alert, they can find that instead of having secure investment they have a very insecure investment. But I don't think that really goes far enough here in terms of the cluster which we have seen. I think if this was an isolated event, that's one thing. But when you start to see the repetition then perhaps the question of whether or not there are more of these out there that are just waiting to happen and blow up in our face, becomes more relevant. And so then, the issue of buyer beware may not be simply sufficient to decide where we are.

My second question: Why hasn't the Federal Reserve Board ever requested the statutory authority to regularly examine broker-dealers that restrict their business to Government securities transactions?

Mr. CORRIGAN. Well, if I can back up a bit, we have over the years had this informal inspection-examination program directed at the primary dealers. Up until 8 or 10 years ago, the market really was largely a market of a relatively handful of firms. It's only in the past decade or less that we have had this virtual explosion in the number of so-called secondary dealers, as technology and everything else, and the growth of the debt itself, as Congressman McCollum said, made all this possible. And certainly, again, while I appreciate the point you made about the problem case in 1977, certainly it was not at least until 1982—1982 was Drysdale—there was no evidence certainly up until then of anything that would strike you as a systematic type problem and indeed one could perhaps argue that it's only in the very recent past that the systematic structure of the thing becomes more evident and suggestive.

I think the feeling was certainly through this whole period that this market, whatever else could be said about it, really does work exceedingly well and that there was a clear danger that regulation could impede the efficiency and liquidity of the market.

I would also suggest that in the recent past at least—not the last 2 months but prior to that time—I can only surmise that the Congress itself would not have been very receptive to the idea of trying to regulate the market, even if someone else had suggested it.

Senator RIEGLE. Well, I don't think it's so much a question of regulating the market. I don't know that there's much appetite for regulating the market. But it's the question of safeguards and monitoring; making sure that this fraud is not turning into an epidemic.

Mr. CORRIGAN. I understand.

Senator RIEGLE. How do you feel about registration of the secondary dealers?

Mr. CORRIGAN. Well, again, as I said to the chairman, there are particular problems that arise there. Now some of them, perhaps the majority of them—I think certainly the majority of them are registered broker-dealers under the Securities Act and are subject to inspection, et cetera, by NASD. But there may be, as I said in my testimony, 100 or maybe more that are fully outside.

Senator RIEGLE. Why is that?

CASE FOR FEDERAL REGISTRATION

Mr. **Corrigan**. At this point, as I said to the chairman, it seems to me that there is a case that registration at the Federal level is indeed a sensible proposition.

Senator **Riegle**. Well, where would the Federal Reserve Board fit into that then? How would you see your role and what part might you envision playing in that?

Mr. **Corrigan**. Well, this gets back again to the questions that the chairman raised about where this interagency—I think at least in my mind it is absolutely clear that the three agencies that I mentioned—the Treasury, the SEC, and we at the Fed—clearly have an interest of some sizable proportion in the market and the market participants. I think that we certainly have to, as a separate straightforward business proposition, maintain a particular relationship with the primary dealers because we trade with them. We have the same business requirement that any participant has. If you're going to be trading with somebody in the amounts of money that we're dealing with, that by its very essence seems to me to call for a particular relationship there.

Now insofar as the other dealers who are not primary dealers are concerned, I think one could very easily argue that the NASD under the SEC or under some joint jurisdictional statutory authority perhaps could discharge those day-to-day responsibilities without great difficulty. But I think that's something that someone other than I should respond to.

Senator **Riegle**. It seems to me, implicit in what you say is the fact that the world has changed.

Mr. **Corrigan**. Yes.

Senator **Riegle**. And what was true 8 or 10 years ago is not true today. There's been a proliferation in this area and just the amount of debt itself that's out there has helped drive the dynamics of what we see. I'm not sure that I'm as readily able to make a distinction between a primary dealer and a secondary dealer in terms of the chain of commerce, if you will, or the activity that sort of originates with the instrument which then makes its way out to an ultimate purchaser. It seems to me we're behind. We're behind the curve here; events have sort of moved ahead in such a way that our response is lagging quite far behind and I'm not comfortable with that. I'm not comfortable with what I heard earlier in response to some of the chairman's questions. I certainly don't mean to reflect on you personally, but I don't know what's the right course of action here.

Let me just ask you one other thing at this point. Preliminary estimates indicated that more than 75 thrifts could lose as much as $200 million with their dealings with Bevel, Bresler & Schulman [BBS] threatening the solvency of several of those institutions and separately the total customer losses from the failure approximated $233 million—a lot of money.

I'm wondering what your latest figures are regarding total customer losses and thrifts affected by the amount of money they stand to lose as it relates to the BBS collapse.

Mr. **Corrigan**. Those estimates are ones that I would associate myself with. Again, I would just caution, it takes a long time, as you very well know, for the trustee in bankruptcy to settle claims, to find out what assets are there and——

Senator RIEGLE. Excuse me. I'm not looking for precise numbers.

Mr. CORRIGAN. But at this point, I think those estimates are as good as I could do.

Senator RIEGLE. Now apart from thrift losses, what about bank losses? Can you give me a number there?

Mr. CORRIGAN. That number, $230 or $240 million, does, Senator, include losses that were incurred at, as I recall, seven or eight banks, including one loss of some size, $50 million or so.

Senator RIEGLE. I'd like you to give us for the record similar figures regarding both customer losses and financial institution losses for the following: for ESM, Line Capital, Lombard-Wall, Drysdale, and Winters Government Securities.

Mr. CORRIGAN. We would be happy to do that.

[The following information was subsequently supplied for the record:]

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, NEW YORK 10045

COPY

June 5, 1985

The Honorable Donald W. Riegle, Jr.
United States Senate
Committee on Banking, Housing
and Urban Affairs
Washington, D.C. 20510

Dear Senator Riegle:

At the Committee's hearing on the government securities market on May 9, you asked for estimates on the losses to investors from failures of six government securities dealers. Those dealers include Bevill, Bresler & Schulman companies, ESM Government Securities, Inc., Lombard Wall,Inc., Lion Capital Group, Drysdale Securities Corporation and Winters Government Securities, Inc.

Based on some rough estimates, the losses from those failures are on the order of $800 million on a pre-tax basis. Among types of investors, losses to banks were about $325 million, thrifts around $375 million and municipal investors about $100 million.

Sincerely,

(Signed) E. Gerald Corrigan

[illegible]

FEDERAL RESERVE BANK OF NEW YORK

NEW YORK, NEW YORK 10045

E. Gerald Corrigan
President

June 11, 1985

COPY

The Honorable Jim Sasser
United States Senate
Committee on Banking, Housing, and
Urban Affairs
Washington, D. C. 20510

Dear Senator Sasser:

During the Committee's May 9 hearing on the Government securities market, you asked that I reply for the record to several additional questions. This letter is in response to your request.

You asked for additional information on how regulation of the Government securities market could add to the cost of financing the public debt. As I see it, there are basically two ways additional regulation could adversely affect the market for Treasury securities. First, regulation could increase the investor's transaction costs. Even a very small increase in the cost of each transaction could make the Government securities market much less attractive to investors relative to alternative investments. These additional transaction costs would arise to the extent that regulation requires customers and dealers to change the way they purchase and hold Government securities. For example, mandating that all investors in repurchase transactions maintain their securities in segregated accounts with a party other than the seller of the securities is the type of regulation that would increase both customer and dealer costs directly. Transaction costs would also increase to the extent that the additional registration, rule-making and inspection costs of any regulatory authorities are passed on to dealers and ultimately to investors.

The second cost of regulation to the Government securities market is more difficult to quantify, but could prove ultimately to be more damaging. That "cost" results from the adverse impact that additional regulation might have on the liquidity of the market. Today, the efficiency and liquidity of the marketplace in Treasury securities is amply demonstrated by the small difference between bid and asked prices in actively traded issues--often only one or two basis points, and sometimes even less. In addition to the loss of investors to other markets because of their increased transaction costs, the liquidity of the Government securities market could be reduced considerably if, in the face of extra regulation of dealer and clearing operations, dealer firms decide to curtail or discontinue their activities. Also, raising the cost of entry into the market will reduce the potential number of distributors of Government securities to customers. Having fewer firms in the market might lead to a lessening of competition and to higher charges by those that remain.

You also asked whether the general public has lost confidence in Government securities themselves as the result of the recent failures of Government securities dealers. While there is no easy way of measuring the effect on public confidence of such failures as ESM Government Securities and Bevill, Bresler and Schulman affiliates (BBS), they have not had a discernible effect on the over-all functioning of the market for U.S. Government securities. The general public has not lost confidence in Treasury securities.

Finally you questioned whether actions by regulators or securities firms have enhanced the "fear factor" among investors in Government securities. Understandably, there has been some repositioning of securities activities among customers. I believe that this has resulted from the well-publicized and significant losses taken by investors who dealt with ESM and BBS and that regulators and dealers have not played up investor fears. Yet, there continues to be need to remain concerned about the impact of ESM and BBS on the market. For example, investors have reacted by reexamining the firms with which they do business, in some cases limiting their dealings only to large firms or to primary dealers. This is a cause for some concern since such actions, should they become widespread, would tend to limit access to the market by not only weak or poorly capitalized firms--a desirable effect--but by well-managed firms as well. Many small and medium-sized dealers are well-capitalized and perform a helpful and important function in the operation of the market. They provide liquidity in this nationwide market by matching purchasers and sellers of securities.

COPY

I am aware that the Federal Home Loan Bank Board has published for comment a proposal that thrift institutions be allowed to purchase over-the-counter options in Government securities only from primary dealers and their affiliates. I would prefer an approach that recognizes the potential for other dealers as well as primary dealers to trade in over-the-counter options with customers in a prudent manner. However, even as it stands, the proposal represents a liberalization of the Bank Board's rules in allowing thrifts to use over-the-counter options to hedge their interest rate risk in addition to exchange-traded options already permitted. At the same time, it attempts to recognize the potentially greater risk in dealing in these options by emphasizing the players in the market that are among those more likely to have the capacity to maintain continuous markets in the instruments.

COPY

Sincerely,

E. Gerald Corrigan

E. Gerald Corrigan
President

Senator **Riegle**. I have been given a note, Mr. Chairman, that my time is up, so why don't I yield and I will go again when you finish.

Senator D'**Amato**. Senator, I only have one question and observation.

First of all, at this point in time, I would like to ask that Senator Cranston's remarks be placed in the record. He also has several questions for the record which we will send to Mr. Corrigan.

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STATEMENT OF SENATOR CRANSTON

Senator **Cranston**. Since May 1982, seven unregulated Government securities dealers have failed due to fraud or excessive risk taking. The most recent of the two failures this year, ESM Government Securities, caused the shutdown of the thrift industry in Ohio. Together with Bevill-Bresler Assets Corp. of New Jersey, these failures have triggered losses that exceed $300 million to towns, school districts, and thrifts.

The two most recent failures added to those of Lion Corp., RTD, Comark and Lombard Securities over the last several years provide ample evidence that there is a breakdown in the market mechanisms, and that some form of Government intervention is necessary. All of the Government securities dealers that failed were unregulated.

Senators Proxmire, Riegel, and I have introduced S. 936, called the Public Securities Act, as the least intrusive way to restore confidence in the Government securities market and to protect the public from further instances of fraud.

The bill would provide for a 17-member rulemaking board, composed of representatives of the securities industry, banks, and the public, with responsibility for developing professional qualification rules for those who buy and sell Government securities; an industrywide registration of personnel engaged in the Government securities business; uniform practice rules relating to the processing, clearance, and settlement of transactions; rules of fair practices, which cover disclosure and business conduct; minimum capital requirements and rules with respect to collateralization.

The new public securities rulemaking board will continue to be a self-regulatory organization with its members equally divided among qualifying representatives of investors in and issuers of public securities.

This bill will be a starting point. I recognize that the SEC, Treasury, and the Federal Reserve have not completed their study and have not made formal recommendations on this subject. However, I welcome the general comments from today's witnesses.

Senator D'**Amato**. Why don't you finish up your line of questioning.

Senator **Riegle**. Thank you, Mr. Chairman.

It's been suggested by some that any legislation dealing with the regulation of the Government securities market should ensure that all qualified dealers have equal trading access to the secondary market for Government securities. What would be your reaction to that suggestion?

Mr. **Corrigan**. Would you repeat it? I'm not sure I caught really the operative part of it.

Senator **Riegle**. It's been suggested by some that any legislation dealing with the regulation of the Government securities market should ensure that all qualified dealers have equal trading access to the secondary market for Government securities.

Mr. **Corrigan**. I think the thrust of that comment is addressed to the question of the so-called use of the broker's wire and related matters so that everyone operates on an equal basis.

Senator **Riegle**. That's right.

BLIND TRADING

Mr. **Corrigan**. I suspect that is it. That's a tough one, Senator, because the broker's wire apparatus by its very nature involves what's called blind trading. It means that if I do a deal with you, I don't know it's you on the other side of that deal. I must say that from my perspective, the generalized extension of blind trading and blind brokering through a market as large as this does not make me very comfortable. In fact, it takes me the other way. I think that again the central precept of these trading relationships is know your counterparty. Now if you institutionalize the marketplace to the point where you take them away, a vehicle that permits that, I think that can be very dangerous.

On the other hand, I certainly agree with the proposition that equitable access and market treatment for these so-called secondary dealers is essential. I think the point was made earlier. There is no question the overwhelming majority of these dealers are out there doing a good job. They are bringing the market to places where it otherwise would not be. In the process, they are adding to the liquidity and they should be in a position where they can indeed function effectively in the marketplace. And that question of how you square the circle of equity, level playing field, call it what you will, against the backdrop of the obvious problems that can be associated with an institutionalized overall system of blind trading and brokering is a very tough issue.

Senator **Riegle**. I agree with you but I gather then that this is something that's being looked at?

Mr. **Corrigan**. It is a very essential aspect of this overall question, yes.

Senator **Riegle**. To what extent was the Federal Reserve aware of ESM and Bevel-Bresler before they occurred?

Mr. **Corrigan**. In the case of ESM, there had been over a period of time various market rumors about that particular firm. Indeed, they can be traced at least in a very scattered way back to the late 1970's. But in the timeframe of late 1983 into early 1984, those market rumors became somewhat more frequent and in response to that people on the staff of the New York Fed did make a number of inquiries with other Federal and State regulatory agencies in an effort to try to see what was behind it.

Indeed, it was for precisely that reason that when we began this voluntary system of monthly reporting for secondary dealers that we invited ESM to participate in that program, and they did. Unfortunately, the reports they gave us were about as good as the reports they gave everybody else. But there was clearly some market sense that reached us that suggested that something didn't quite smell right there and we did make some efforts to follow up on it.

In retrospect, we probably should have been a hell of a lot more aggressive on following up on it, but again, this is where this problem of authority comes into play because given our more recent experience I have a feeling that if we went down and knocked on the door they would have told us on advice of counsel, as we have been told more recently, sorry, can't do a thing for you.

Senator RIEGLE. Is that to say that there have been other instances recently of other companies where you tried to press and get additional information and you have been stiff armed?

Mr. CORRIGAN. Yes.

Senator RIEGLE. How often has that happened?

Mr. CORRIGAN. I wouldn't want—there have been one or two cases like that, not a lot of them. One of a mild variety and another of a somewhat—I wouldn't use the term "stiff arm"—I think it's more—maybe I would in one case.

Senator RIEGLE. Well, I think that's interesting to know and I would just say to the chairman that that's the kind of thing that needs to be brought to our attention. If you're finding that there are situations that you are uneasy about and that you felt the need on the basis of voluntary reports to want to dig deeper and you're finding that you're unwelcome in terms of getting the information that you need, it sounds to me like that's an unacceptable situation. That's when the red flag ought to go up.

Mr. CORRIGAN. Let me just respond to the second part of your question on BBS. In that case, again, BBS was a registered SEC—BBS, Inc.—there were about six companies all loosely connected here—BBS, Inc., if I've got this right, was a SEC-registered broker-dealer subject to NASD inspection, et cetera, and that entity was also one of these monthly reporting Government securities dealers. In that particular case, the reporting as well as the SEC oversight and NASD oversight just applied to that one entity and not to any of the affiliated—again, the affiliation was largely by name. It was not a holding company type of structure—none of that applied to any of the other companies and insofar as the lead entity was concerned, in that case I think I can say that we had no prior knowledge or even rumors of problems in that case until Good Friday evening when the situation was brought to our attention. In the course of that on Easter Sunday the first of the BBS affiliates was put into bankruptcy.

REQUIRE COLLATERAL

Senator RIEGLE. Let me just cover two things very quickly in the interest of time.

What is your reaction to the recommendation by some that thrifts, local governments, and other Government securities market players be required to obtain collateral, actually get in hand when they engage in repurchase agreements or repos with Government securities dealers?

Mr. CORRIGAN. The thrust of it I completely agree with. I would I guess quibble a bit with two words. One was require and the other was I think you said obtain. Require can be—you've got to be a little bit careful there, but the key word is obtain. I don't think it is necessary even in the case of a town or a small thrift to literally obtain on their own books or in their own hot hands the collateral associated with a RP transaction. I think they should certainly be absolutely certain that they are able to secure control over the collateral and that can be done by insisting on a written agreement that when they do a trade with dealer X that dealer X under a written agreement has to deliver the collateral to a segregated account at the dealer's bank or a third bank, but it's not literally necessary, in my judgment, to go to the point of controlling in the physical possession sense.

Senator RIEGLE. But you would then favor a segregation as an ironclad rule on a third-party segregation, and you would feel that that would be beyond the reach of the pattern of fraud that we have seen in these other cases?

Mr. CORRIGAN. Well, what I've seen in the last few weeks, Senator, I'm not sure anything is beyond the pattern of fraud anymore, but I would want to be a little careful how this should be drafted, either in statute or regulation.

Senator RIEGLE. Help us draft it. If we're going to move that way, I'd be interested in your sense of the need. In other words, I'm interested in confidence. I want the markets to work and I don't want people to be schilled out of their money. I mean, if somebody is wildly miscalculating in their investment decisions, that's one kind of thing, but in the standard course of events, if thoughtful, well-meaning investors are being defrauded on a large scale because we just don't have the mechanisms in place to afford the kind of institutional protections, I think we ought to have them.

So I guess what I'm asking you is what more seems to be needed here if we set aside the question of absolute personal physical control, how can we have this third-party system work so that it's basically foolproof?

Mr. CORRIGAN. The other thing one has to be sensitive to is what that, while those arrangements—you used the word confidence and other things—I think they do make sense in the case of depository institutions and particularly smaller ones and municipalities and so on. I would be a little reluctant to say as a matter of law and regulation that that apparatus applied across the board to everyone under all circumstances.

For example, I think you may need a little breathing room certainly insofar as the overnight RP market among the pros so to speak is concerned. I think requiring this obtaining, even by my definition—obtaining control, if literally pasted across the board, applied to every single transaction, to every single class of institution, to every single market participant is one of the things that I think is obtainable over time, but in the short run could be quite destabilizing.

So if we are talking about depository institutions, if we are talking about municipalities and so on, yes, and there is, for example—Mr. Kelly may want to talk about this later. His group, for example, is trying to develop a standard RP contract. A contract itself is kind of central to this thing because if a small town or a small thrift has the right contract arrangement with the dealer and as part of that contract these terms providing for securing control of the collateral are spelled out, then I really think you have gone a very, very, very long way in dealing with the problem, subject again with the caveat that there's no system that can provide absolutely fail-safe protection against fraud, particularly the egregious types of apparent fraud that we have seen.

Senator Riegle. It seems to me—and I will just finish with this—that the Fed has an interest in wanting to find ways and means to start tracking down outfits out there that are operating fraudulently where they are out doing business way beyond what their true net worth is and it's just a question of when the house of cards topples. I think to allow instances like that to be out there and not be ruthless in finding them is really not fully meeting your responsibility.

Today in the Wall Street Journal—I don't know if you've had a chance to have seen it yet, but the lead story on the right-hand column is "Soaring Levels of Debt, National and Private, Causing Rising Worries." It goes on to talk about the debt pyramid that's being built up and that's just one story. There are many others on a lot of other things—deflation in farm values and a whole host of things working simultaneously. It didn't take very long for the psychology in Ohio in the unique case with the State-insured thrifts to move at lightening speed through that State and create something of a State banking crisis until it was resolved. Confidence is a funny thing—you have confidence until all the sudden you don't have confidence, and you don't necessarily know when that's about to change. I like things that are confidence building, like reducing deficits, like figuring out not only how we dig out of a fraudulent situation when they collapse on us but how we track these people down and how we make it as difficult as possible for them to operate for 1 day out there when in fact they are putting the whole system in jeopardy if you've got a period of time when confidence is fragile, as I think we do now.

So I would hope that the Fed, recognizing that the world has changed, would not find itself locked in old patterns. I would hope that the Fed would be willing to—in the view of maintaining open markets—take the additional steps that are needed here to identify the faults in the system and work to correct them. But then I think you have to come to us quite frankly and say, "Look, this is where we think we need some additional help here in terms of jurisdictional reach," or "They ought to be lodged somewhere else, but that we want to maintain orderly markets and public confidence and this is what we think needs to happen."

So I think there is an affirmative obligation here to try to come to a bottom line in what you think you could do and what you might suggest we do.

Mr. Corrigan. I agree with that, Senator. I agree with the whole thrust of your comments. I just would want to again offer one little caveat. I think there is nothing perhaps more important than getting frankly what I call the gunslingers out of the marketplace, but in the process of trying to do that you have to go to great lengths to protect the innocent—and as I said, there are hundreds of these small firms out there that I think it would be a gross miscarriage of the public interest if inadvertently or otherwise some of them got painted with a brush they shouldn't be painted with. So you've got to be careful on that score.

Second, you also have to be careful because of these interdependencies. This is a very, very dynamic marketplace and it works wonderfully well, but it is one that has to much of this interdependent nature with the depository institutions, with other financial markets, that you have to be careful.

Senator RIEGLE. I thank you. The chairman tells me we must move now because we are up against a vote and we've got another witness.

Senator D'AMATO. Thank you very much, Senator Riegle.

Mr. Corrigan, let me thank you for your testimony. Let me also suggest to you that it would seem to me inherent in some of the things you've said that were we to have, for example, registration requirements with the Federal Government of securities dealers, at least broad financial standards, at least reporting requirements, onsite inspection ability for you or another agency, and enforcement authority, I would take it that some of the problems that have occurred could have been eliminated, regardless of the fact that it was fraud. Would that be an accurate statement?

Mr. CORRIGAN. This is one of these what if questions.

Senator D'AMATO. All right. What if? What if we had all of those?

Mr. CORRIGAN. To say eliminate it——

Senator D'AMATO. I didn't say eliminate all of them.

Mr. CORRIGAN. The probabilities work in that direction, I would accept, but I think it's a stretch to say that even if you had this, any of these problems would have been eliminated.

SOME COMPANIES UNDERCAPITALIZED

Senator D'AMATO. Well, some of these companies were undercapitalized, weren't they?

Mr. CORRIGAN. Well, in the case of ESM, for example, that Senator Riegle inquired about, sure, they were undercapitalized, but——

Senator D'AMATO. So if you had this requirement and this reporting, et cetera, isn't there a good likelihood that——

Mr. CORRIGAN. I would say in an egregious case like that where again there apparently was fraudulent financial statements, inspection onsite is the only thing, in my judgment, that has a chance of catching that. But to say that even inspection is absolutely fail-safe, I'm just not prepared to say that.

Senator D'AMATO. Nobody is suggesting that inspection or the best laws in the world are fail-safe.

Mr. CORRIGAN. That's all I want to say.

Senator D'AMATO. We understand that. The question is, is it necessary for some reform at this time outlining broadly those areas that you have suggested where you do not have the ability to undertake the inspection if someone is going to stiff you, where you don't have the registration, someone used that word, would that not be preferable to the situation which exists today which is basically voluntary compliance?

Mr. **Corrigan**. Well, again, as I see the situation right now, I clearly am not happy, but—I know this isn't going to make you happy, but I want to reserve the right to make a final judgment until I get a little more fact in hand, until I think that we in the three agencies that I mentioned have had a chance to satisfy ourselves that we're all on the same wavelength.

Senator D'**Amato**. Then you're going to make that report in June?

Mr. **Corrigan**. Well, I hope we can make it a lot sooner than that. I said no later than mid-June. I genuinely hope it can be done a lot sooner than that.

Senator D'**Amato**. Well, I hope so because there is a feeling of I think very real concern as evidenced by the questions that my colleagues asked in connection with this so that we don't have that unsophisticated investor, regardless of what we tell them they should or shouldn't be concerned about—we don't have that investor who really doesn't have the expertise in financial management—the local village or school district—that is attempting to earn a higher yield and some additional revenues, or the unsuspecting person, senior citizens, et cetera, as Senator Hawkins testified, that gets themselves into a fix. So certainly, while we are very sensitive not to disturb the liquidity of the market, placing an undue burden and creating more chaos, I think it is important that we do the best we possible can in seeing to it that we curb as many of those possibly abuses as possible.

I am very appreciative of your time and your testimony and of your graciousness as well.

Mr. **Corrigan**. Thank you, Senator.

Senator D'**Amato**. We are going to call our next witness, and I'm going to try to race those buzzers, so to speak, Mr. Richard Kelly, chairman, Government and Federal agency securities division, Public Securities Association.

STATEMENT OF RICHARD M. KELLY, CHAIRMAN, GOVERNMENT AND FEDERAL AGENCY SECURITIES DIVISION, PUBLIC SECURITIES ASSOCIATION

Mr. **Kelly**. Mr. Chairman, my name is Richard M. Kelly. I am president of Aubrey G. Lanston & Co. and chairman of the Public Securities Association's Primary Dealers Committee.

We appreciate the opportunity to testify on the need for regulation of the U.S. Government securities market and to comment on S. 936, also known as the Public Securities Act of 1985. I will only summarize our written statement and respectfully ask that the full text be inserted in the hearing record.

Senator D'**Amato**. So ordered.

Mr. **Kelly**. At the outset, I would like to note that we believe specific new legislation is necessary to address identifiable weaknesses in the Government securities market. However, we do not support enactment of S. 936, because it is unnecessarily broad in scope, it fails to acknowledge the unique characteristics of the Government securities market and risks diminishing the market's efficiency and liquidity.

SPECIFIC RULEMAKING AUTHORITY

As I will further describe, we would favor enactment of legislation granting specific rulemaking authority to the Federal Reserve Board with enforcement of those rules by either the Federal Reserve, the SEC, or other appropriate regulatory agencies. Under our proposal, the Fed rules would include a registration requirement, a capital adequacy standard, inspection and enforcement procedures, and specific measures to help prevent fraud in connection with repurchase transactions.

As to investors, we would suggest that regulatory agencies or other responsible bodies establish more carefully defined prudent investment management standards. A model already exists in the form of the ERISA class exemption permitting pension funds to invest in repos, which requires proper documentation, marking to market, and similar precautions, and also requires that the repos counterparty be a registered broker-dealer, bank or reporting primary dealer.

We believe this two-track approach is necessary because what we have witnessed recently represents a combination of capricious, and in some cases, illegal acts committed by certain unregulated dealers, supported in part by irresponsible behavior by some of their customers.

The Government securities market is the cornerstone of the U.S. capital market system. Its role is unique and vital to the functioning of our Nation's economy. We believe that great care should be taken to assure that the integrity and efficiency of the Government securities market is not impaired by any new legislation adopted to regulate this market.

The Government securities market serves as the means through which the U.S. Treasury finances the national debt and provides the ability for the Government to meet seasonal shortfalls between its receipts and expenditures. This market also is the primary vehicle for the Federal Reserve Board to execute domestic monetary policy. Moreover, banks, other financial institutions, insurance companies, pension funds, and corporations are all important investors in U.S. Treasury securities. So too are foreign central banks and other foreign financial institutions.

The U.S. Government securities market is the world's largest, most efficient, and liquid securities market. It is not unusual for more than $200 billion of Government securities to be traded in a single day. Currently, there are more than $1.3 trillion of marketable Treasury debt outstanding.

Senator D'AMATO. Mr. Kelly, if you would, I'm going to ask that we take a 15-minute recess. I'm going to go down and vote and in this way you can conclude your presentation without rushing it because I've got about 3 minutes left for me to get down there. So we will take about a 15-minute recess and come back.

[Recess.]

Senator D'AMATO. We will continue with Mr. Kelly's testimony.

Mr. KELLY. Thank you, Mr. Chairman.

In light of this market's enormous size and significance, we wish to suggest to the Congress that a careful and deliberate approach is necessary in addressing the need for regulation. Through the years, this market has operated with an extraordinary degree of efficiency. Recent publicity to the contrary, the market's efficiency continues to this day, despite the strains created by the ever-increasing Federal budget deficits. Accordingly, we urge the Congress to consult fully with the SEC, the Treasury, and the Federal Reserve Board which have promised to report to the Congress with their evaluation and review as soon as possible.

CONCERN OF RECENT FAILURES

The Primary Dealers Committee is very concerned about the recent failures in the Government securities market and the long-term effects they may have on public confidence in this market. For this reason, we believe that the best interests of the market and its customers would be served by legislation which establishes rulemaking authority with the Federal Reserve Board for application to all Government securities dealers and brokers, as well as their Government securities subsidiaries and affiliates. We would suggest that this authority be exercised with measured restraint to address only identifiable weaknesses in the market. In addition, this legislation should require Fed consultation with the Treasury Department and other appropriate regulatory agencies before approval of any rules.

The purpose of this legislation should be to promote and maintain the integrity of the Government securities market. It should not seek to eliminate losses to lesser sophisticated investors from imprudent or irresponsible business and trading practices, nor should it seek to eliminate the potential for failure by dealer firms which participate in this market.

We suggest that the Fed's rulemaking authority specifically include a registration requirement, a capital adequacy standard, inspection and enforcement procedures, and rules or guidelines to prevent fraud in connection with repurchase transactions. Also, the Fed's rules should be structured in such a fashion as to acknowledge the unique role of the primary dealers in the Government securities market.

In addition, we suggest that inspection and enforcement authority under the Fed's rules should be vested in the regulatory agency with principal oversight for the institution involved. In the case of banking institutions, this would be either the Comptroller of the Currency, the Federal Deposit Insurance Corporation, or the Federal Reserve Board, depending upon the structure of the institution. In the case of registered broker-dealers, and currently unregulated dealers, this would be the SEC and NASD. In the case of the primary dealers, it would be the Federal Reserve Board.

Finally, the Primary Dealers Committee believes that any efforts to address possible weaknesses in the Government securities market must concurrently address the issue of improving business and trading practices in the use of repos. We do not believe it is necessary, however, to mandate the delivery of all repo collateral. Such a solution could have broad and unintended implications not only on the Government securities market, but perhaps broader and more significant ramifications in the mortgage-backed securities market, and in the liquidity of many other money market instruments, including commercial paper, bankers' acceptances, and certificates of deposit. A delivery requirement could prove impractical, time-consuming and inefficient from a cost perspective—especially in the case of repos involving certificated securities. There are currently well-accepted industry practices involving the segregation of repo collateral which enable a party to obtain a perfected security interest, without having physical possession of the collateral. These segregation requirements should be acknowledged as an accepted alternative when delivery of collateral is not practical or cost effective.

Mr. Chairman, I would next like to highlight some of the specific reasons why we do not support S. 936. First, we do not believe that the creation of a self-regulatory organization [SRO], like the proposed Public Securities Rulemaking Board [PSRB], is appropriate or necessary. We are particularly concerned about the mandate that would be given to any SRO and the consequent scope of rulemaking it would pursue. The regulations it would have the capacity to promulgate could fundamentally change a marketplace which is not in need of such reconstruction. In our view, there are specifically identifiable areas of operation of the market which need further examination and adjustment, but there is a great deal more about the Government securities market that continues to work extraordinarily well and should not be changed, altered, or hampered through regulation.

Second, we believe that establishment of an SRO could be costly. If the efficiency and liquidity of the market were diminished by broad regulation, the Treasury's borrowing costs would increase, thereby resulting in higher tax burdens for American citizens. If Treasury's cost of borrowing increased by as little as 10 basis points as a result of regulation, the cost to the Treasury could be $2.2 billion over the life of the securities issued during the first year. The other, more direct costs would include the cost of compliance with the regulations themselves and the costs associated with funding the expenses of the SRO and its staff.

The Primary Dealers Committee's recommendations minimize these costs and expenses; first, by working with currently existing institutions and regulatory bodies and, second, by imposing only specific rules directed at identifiable weaknesses in the market.

Third, we believe that S. 936 fails to acknowledge the unique characteristics of the Government securities market. With certain minor exceptions, S. 936 tracks the statutory approach taken in the Securities Act Amendments of 1975, the legislation which established the regulation of the municipal securities market and which created the Municipal Securities Rulemaking Board. The legislation merely makes some minor adjustments to section 15B of the Securities Exchange Act of 1934, and changes the name of the MSRB to the Public Securities Rulemaking Board. It implies a level of comparability between these two markets which, in fact, doesn't exist. To assume that by adding a few representatives of the Government securities industry to the MSRB that one could effectively regulate both markets might sound academically attractive, but in our view is shortsighted and raises substantial risks. The structure and functioning of the municipal and Government securities markets are so different as to make application of the approach described in S. 936 unsuitable. More significantly, S. 936 fails to adequately acknowledge the macroeconomic issues raised when changes are proposed in a market which is so important to the execution of monetary policy, fundamental to financing our national debt and so involved in providing liquidity to our entire banking and international financial system.

Finally, we believe S. 936 mistakenly assumes that the legislative approach enacted in 1975 to address the problems in the municipal securities market is now appropriate for application to the Government securities market. However, the problems existing in the municipal securities market in the early 1970's were quite different from the particular areas of vulnerability facing the Government securities market today.

In the early 1970's, several fraud actions were brought by the SEC against municipal securities professionals for improper and unethical trading and selling practices, most of them involving individual investors. At the same time, increased numbers of institutional investors were participating in the municipal markets. These factors indicated a greater need for individual investor protection. Even today, approximately 80 percent of municipal securities are sold to individual investors.

DOMINATED BY INSTITUTIONAL INVESTORS

On the other hand, the Government securities market remains a wholesale, not a retail market. It is still dominated by institutional investors. In addition, the pattern of abuse which existed in the municipal securities market was quite different in nature from the imprudent activities we have witnessed in the Government securities market. The problems in the Government securities market have not been ones involving market manipulation or widespread deception of individual investors. Given the narrow conjunction of imprudent investors and unregulated dealer insolvencies that gave rise to the problems in the Government securities market, the approach taken in S. 936 misses the mark and risks diffusing the attention that should be focused on dealer capitalization requirements and the prevention of fraud in connection with repurchase transactions.

In closing, Mr. Chairman, we would like to emphasize that we believe a multifaceted response is necessary to address current market concerns. This response should include the development of new legislation granting specific rulemaking authority to the Federal Reserve Board over all Government securities dealers and brokers. Concurrently, we suggest that regulatory agencies or other responsible bodies establish carefully defined prudent investment management standards for investors.

In addition, we believe that in considering any change in the level of regulation or supervision of activities in the Government securities market, one must carefully balance the potential costs of regulation against the benefits the public hopes to realize. Therefore, we strongly suggest careful consideration of any proposed regulatory or legislative change, particularly given the risks to both the world economy and the public associated with any impairment of the efficient functioning of the Government securities market.

We would be pleased to provide whatever assistance is necessary or appropriate.

Thank you, Mr. Chairman.

[The complete prepared statement follows:]

STATEMENT OF RICHARD M. KELLY*, CHAIRMAN OF THE PRIMARY DEALERS COMMITTEE OF THE PUBLIC SECURITIES ASSOCIATION, BEFORE THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, SUBCOMMITTEE ON SECURITIES OF THE UNITED STATES SENATE

INTRODUCTION

The Primary Dealers Committee of the Public Securities Association ("PSA") welcomes this opportunity to testify before the Subcommittee on Securities on the need for regulation of the U.S. government securities market, and to comment on S. 936, also known as the Public Securities Act of 1985. PSA is the national trade association which represents approximately 300 banks, dealers and brokers that underwrite, trade and distribute U.S. government and federal agency securities, mortgage-backed securities, and state and local government securities. All 36 primary dealers in government securities, as recognized by the Federal Reserve Bank of New York, are members of the Primary Dealers Committee, as well as members of PSA.

As you know, Mr. Chairman, the overwhelming majority of government securities dealers are already subject to regulation by either the Federal Reserve, the SEC or one of several other bank regulatory agencies. Yet the ESM and Bevill Bresler failures and other recent events have revealed major gaps in this regulatory scheme. Perhaps most important, there are estimated to be about 150-200 government securities dealers that have not yet been subjected to effective regulation or monitoring. Furthermore, there are several important categories of regulated investors that apparently still do not have effective investment management standards for participation in the government securities market.

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We believe that specific new legislation is necessary to deal with identifiable weaknesses in the government securities market. As I will further describe, we would favor enactment of legislation granting specific rulemaking authority to the Federal Reserve Board with enforcement of those rules by either the Federal Reserve, the SEC or other appropriate regulatory agencies. Under our proposal, the Fed rules would include a registration requirement, a capital adequacy standard, inspection and enforcement procedures, and specific measures to help prevent fraud in connection with repurchase transactions.

As to investors, we would suggest that regulatory agencies or other responsible bodies establish more carefully defined prudent investment management standards. A model already exists in the form of the ERISA class exemption permitting pension funds to invest in repos, which requires proper documentation, marking to market, and similar precautions, and also requires that the repo counterparty be a registered broker-dealer, bank or reporting primary dealer.

We believe this two-track approach is necessary because what we have witnessed recently represents a combination of capricious, and in some cases, illegal acts committed by certain unregulated dealers, supported in part by irresponsible behavior by some of their customers. However, given the risks associated with imposing unnecessarily broad regulation of the government securities market, we would not support S. 936 in its present form. As I will discuss in more detail, we believe that the Municipal Securities Rulemaking Board model is not appropriate for the government securities market.

PROTECTING EFFICIENCY OF THE GOVERNMENT SECURITIES MARKET

The government securities market is the cornerstone of the U.S. capital market system. Its role is unique and vital to the functioning of our nation's economy. We believe that great care should be taken to assure that the integrity and efficiency of the government securities market not be impaired by any new legislation adopted to regulate this market.

The government securities market serves as the means through which the U.S. Treasury finances the national debt and provides the ability for the Government to meet seasonal shortfalls between its receipts and expenditures. This market also is the primary vehicle for the Federal Reserve Board, through its Federal Open Market Committee and the Open Market Desk at the Federal Reserve

Bank of New York to execute domestic monetary policy. Moreover, banks, other financial institutions, insurance companies, pension funds and corporations are all important investors in U.S. Treasury securities. So too are foreign central banks and other foreign financial institutions.

The U.S. Government securities market is the world's largest, most efficient and liquid securities market. It is not unusual for more than $200 billion of government securities to be traded in a single day. This market provides an extremely efficient means for all participants to hold and trade government securities The speed efficiency and low transactional expense have contributed significantly to the liquidity and attractiveness of this market to investors.

Currently, there are more than $1.3 trillion of marketable debt outstanding. This market consists of both a primary market through which new issues of U.S. government securities are sold to the public, and secondary markets in which outstanding government securities are traded. Over the last few years, the U.S. Government has been virtually a continual participant in the primary market. It has had to raise more than $200 billion in new funds each year to finance the deficit, and it has had to refinance hundreds of billions of dollars more of maturing debt. Even larger volumes of trading will be necessary to accommodate the future growth of government debt, which under current policies as estimated by the Congressional Budget Office will reach $2.5 trillion by the end of fiscal 1989.

In light of this market's enormous size and significance, we wish to suggest to the Congress that a careful and deliberate approach is necessary in addressing the need for regulation. Through the years, this market has operated with an extraordinary degree of efficiency. Recent publicity to the contrary, the market's efficiency continues to this day, despite the strains created by the ever-increasing federal budget deficits. Accordingly, we urge the Congress to consult fully with the SEC, the Treasury and the Federal Reserve Board which have promised to report to the Congress with their evaluation and review as soon as possible.

THE CAUSE OF CONCERN

Recent events have focused a great deal of attention on the government securities market from the Congress, the Federal Reserve Board and other banking and securities regulators, the media and others. We all are concerned about the imprudent, and in some cases perhaps fraudulent, activities of participants such as Drysdale, Comark and Lombard-Wall in 1982, Lion Capital and RTD Securities in 1984, and most recently, the situations relating to E.S.M. and Bevill Bresler. These incidents warrant the close attention of the Congress and all participants in this market.

There are two common elements to the recent incidents in the marketplace. First, none of the institutions most directly involved was subject to on-going regulation. They were all unregulated institutions (although in some instances they were affiliated with, or subsidiaries of, regulated institutions).

Second, most of these incidents involved abuses in the use of repurchase agreements. This instrument is critically important to maintaining liquidity and efficiency in the government securities market. It is an instrument which is used virtually on a daily basis by the Fed in order to execute domestic monetary policy and by government securities dealers to finance their inventories.

PSA and the primary dealers are as concerned as the Congress and the financial regulatory community with the apparent continued existence of imprudent market practices and alleged illegal activities of some market participants. These incidents are disruptive to the course of free markets and take undue attention away from our efforts of managing risk in an uncertain economic environment.

What is particularly troubling are the significant losses taken by the small and less sophisticated public investors, especially in the incidents involving the failures of Lion Capital E.S.M. and Bevill, Bresler. Many school districts, public authorities, state and local governments and smaller financial institutions throughout the country have been affected. These losses have already trickled down to state and local taxpayers and to depositors at some of these smaller financial institutions.

THE QUESTION OF REGULATION

Recent public attention has again brought into focus the basic issues of conduct, supervision and oversight of the government securities market. Today, more than ever, there appears to be a need for regulation of this marketplace. In examining this issue we think it would be helpful to review an excerpt from the remarks of Anthony M. Solomon, former President, Federal Reserve Bank of New York, in his testimony before this Subcommittee on April 25, 1983.

> The next question is whether the current self-regulatory structure should be made more formal than it has been, and whether the Federal Reserve's oversight role should be made more explicit through the legislative process. On balance, I conclude that those steps are not necessary at this time. I think we should keep in mind that the losses incurred in last year's three failures--unpleasant and undesirable though they were--fell almost entirely on large and sophisticated market participants, rather than on small individual investors. (Emphasis added)

The situation has obviously changed from that which existed in 1983. As pointed out earlier, the failure of Lion Capital in 1984 E.S.M. in early March 1985 and Bevill, Bresler in April 1985 have resulted in losses that will ultimately be imposed directly on many state and local taxpayers and depositors in affected financial institutions.

The Primary Dealers Committee is very concerned about these recent failures and the long-term effects they may have on public confidence in the government securities market. For this reason, we believe that the best interests of the market and its customers would be served by legislation which establishes rulemaking authority with the Federal Reserve Board for application to all government securities dealers and brokers (and their government securities subsidiaries and affiliates). We would suggest that this authority be exercised with measured restraint to address only identifiable weaknesses in the market. In addition, this legislation should require Fed consultation with the Treasury Department and other appropriate regulatory agencies before approval of any rules.

The purpose of this legislation should be to promote and maintain the integrity of the government securities market. It should not seek to eliminate losses to lesser sophisticated investors from imprudent or irresponsible business and trading practices, nor should it seek to eliminate the potential for failure by dealer firms which participate in this market.

We suggest that the Fed's rulemaking authority specifically cover a registration requirement, a capital adequacy standard, inspection and enforcement procedures and rules or guidelines to prevent fraud in connection with repurchase transactions.

Also, we recommend that the Fed be granted the flexibility to exempt any government securities dealer or class or category of government securities dealers from any rules or regulations it promulgates. Moreover, the Fed's rules should be structured in such a fashion as to acknowledge the unique role of the primary dealers in the government securities market.

In addition, we suggest that inspection and enforcement authority under the Fed's rules should be vested in the regulatory agency with principal oversight for the institution involved. In the case of banking institutions, this would be either the Comptroller of the Currency, the Federal Deposit Insurance Corporation or the Federal Reserve Board, depending upon the structure of the institution. In the case of registered broker-dealers, and currently "unregulated" dealers, this would be the SEC and NASD. In the case of the primary dealers, it would be the Federal Reserve Board.

The Federal Reserve has a vital interest in maintaining a healthy and viable market for government securities. Respecting this interest, as well as the Fed's market knowledge and integrity, it is appropriate, in our view, to extend its mandate.

Finally, the Primary Dealers Committee believes that any efforts to address possible weaknesses in the government securities market must concurrently address the issue of improving business and trading practices in the use of repos. We do not believe it is necessary, however, to mandate the delivery of all repo collateral. Such a solution could have broad and unintended implications not only on the government securities market, but perhaps broader and more significant ramifications in the mortgage-backed securities market, and in the liquidity of many other money market instruments, including commercial paper, bankers' acceptances and certificates of deposit. A delivery requirement could prove both impractical, time-consuming and inefficient from a cost perspective -- especially in the case of repos involving certificated securities. There are currently well-accepted industry practices involving the segregation of repo collateral which enable a party to obtain a perfected security interest, without having physical possession of the collateral. These segregation requirements should be acknowledged as an accepted alternative when delivery of collateral is not practical or cost effective.

The use of carefully enforced segregation requirements has long been standard practice for regulated bank and non-bank securities dealers with regard to government and non-government securities. We believe that the Fed, the SEC and the other financial regulatory agencies would have no difficulty in developing and enforcing such segregation requirements in the repo market to the extent these requirements do not already apply.

THE MARKET'S SELF-REGULATORY EFFORTS

During the last three years, the primary dealers have successfully implemented a series of self-regulatory steps to adjust to a changing market environment and the known weaknesses inherent to the market. We believe that these actions, which have been undertaken in cooperation with the Federal Reserve Bank of New York and the Treasury Department, have helped create a more stable and sound government securities market. Unfortunately, these self-regulatory efforts have not been followed by a number of the unregulated dealer institutions and some of their customers.

Permit us to cite some examples of the market's successful self-regulatory efforts:

1. Following the Drysdale incident, the Fed, with the cooperation of the primary dealer community, implemented industry-wide changes in pricing practices to require inclusion of the value of accrued coupon interest and accrued repo interest in repo transactions. This method of calculating the liquidation value of repo transactions has become standard industry practice.

2. In the fall of 1982 PSA published a booklet entitled "Business Practice Guidelines for Participants in the Repo Market." This booklet was published with the hope that it would

serve to increase attention to the credit and financial implications inherent in repo transactions. PSA has distributed approximately 38,000 copies of this pamphlet.

3. Following the September 16, 1982 bench ruling of the Bankruptcy Court in Lombard-Wall, the Federal Reserve Bank of New York and PSA, working together, drafted a set of amendments to the Bankruptcy Code. These amendments, which were signed into law on July 10, 1984, as part of the Bankruptcy Amendments and Federal Judgeship Act of 1984, restore a party's ability to liquidate certain underlying securities in a timely fashion in the event of a bankruptcy filing by one's counterparty. PSA has also continued to work with the Federal Deposit Insurance Corporation and the Securities Investor Protection Corporation to gain adoption of formal written procedures which would also insure the expeditious close-out of repos. It should be further noted that in October, 1984, the Federal Home Loan Bank Board adopted a resolution which closely parallels the repo bankruptcy amendments. This resolution provides that in the absence of fraud or other extraordinary circumstances, the Federal Savings and Loan Insurance Corporation should not attempt to stay, avoid or otherwise limit the contractual right of a repo participant to liquidate.

4. In May 1983, the Association of Primary Dealers merged with PSA. This created the vehicle for the entire government securities dealer community to speak with a single voice on issues

of common concern. More importantly, it provided full time staff support for the primary dealers permitting them to broaden their educational efforts.

5. In the fall of 1983, the Fed, the Treasury and the primary dealer community agreed to a combination of actions to reduce credit risk exposure created by lengthy periods of when-issued (wi) trading. The Treasury agreed to reduce the number of days of wi trading by shortening the period of time between auction date and settlement date. In addition, at the suggestion of the primary dealers the Federal Reserve Bank of New York has implemented an expanded reporting system so that primary dealers now have to report daily all net customer wi transactions in excess of $10 million.

6. Over the course of the last year, PSA has been participating on industry task forces with both the Federal Home Loan Mortgage Corporation ("FHLMC") and the Federal National Mortgage Association ("FNMA") to establish book-entry systems for their securities. We have also worked with the MBS Clearing Corporation and Chemical Bank in creating a depository environment for Government National Mortgage Association ("GNMA") securities. These efforts will help reduce existing clearance and settlement inefficiencies in the government securities secondary markets.

7. In February 1985 the Primary Dealers Committee adopted a series of trading practice recommendations relating to the Treasury's new STRIPS (Separate Trading of Registered Interest and Principal of Securities) Program.

8. Finally, the Federal Reserve Bank of New York, in cooperation with representatives of the primary dealers, have worked to refine the capital adequacy guidelines. Over the course of the last year, two PSA committees have been meeting to provide technical advice and assistance on this proposal.

We must emphasize that the success of these efforts is built on the formal business relationship which exists between the Fed and the primary dealer community. No such relationship and/or oversight exists between the Fed and other government securities dealer participants.

REASONS FOR OPPOSITION TO S.936

S. 936 would replace the 15-member Municipal Securities Rulemaking Board with a new 17-member Public Securities Rulemaking Board (the "PSRB"), which would include brokers and dealers in government securities. Other members would represent municipal brokers and dealers, and the public. The PSRB would be authorized to promulgate rules, subject to the approval of the for both the government and municipal securities industries. If enacted, this bill would impose on the dealers in the government securities market a set of regulations identical in scope to that which currently exists in the municipal securities market. For the following reasons, we believe this proposal is overly broad in scope and raises the risk of creating a regulatory structure which may impede market efficiency and thereby raise the cost of issuing the public debt, a cost ultimately imposed on the taxpayers of this country.

1. Establishment of a Self-Regulatory Organization for the Government Securities Dealers is not Necessary

We do not believe that the creation of a self-regulatory organization ("SRO") is appropriate or necessary. We are particularly concerned about the mandate that would be given to any SRO and the consequent scope of rulemaking it would pursue. The regulations it would have the capacity to promulgate could fundamentally change a marketplace which is not in need of such reconstruction. In our view, there are specifically identifiable areas of operation of the market which need further examination and adjustment, but there is great deal more about the government securities market that continues to work extraordinarily well and should not be changed, altered or hampered through regulation. We believe that the best way to insure the maintenance of the highest level of integrity in the government securities market is through the adoption of a new legislative initiative giving the Federal Reserve specific rulemaking authority over all government securities dealers. This legislative authority should be used as a vehicle to implement the Federal Reserve's capital adequacy standard and as a means of preventing fraud in connection with repurchase transactions.

2. Establishment of a Self-Regulatory Organization Could be Costly and Would Add Another Level of Regulatory Oversight

The Primary Dealers Committee believes that establishment of an SRO could be costly. If the efficiency and liquidity of the market were diminished by broad regulation, the Treasury's borrowing costs would increase thereby resulting in higher tax burdens for American citizens. If Treasury's cost of borrowing increased by as little as 10 basis points as a result of regulation, the cost to the Treasury could be $2.2 billion in added expense during the first year, and substantially more in the future. The other, more direct costs would be the cost of compliance with the regulations themselves and the costs associated with funding the expenses of the SRO, and its staff.

One of the benefits of the Primary Dealers Committee's recommendations is that these costs and expenses can be minimized by working with currently existing institutions and regulatory bodies. As mentioned earlier, the overwhelming majority of government securities dealers are already subject to regulation by the Federal Reserve, the SEC or one of the federal banking regulatory bodies. Our legislative approach would avoid adding yet another level of regulatory oversight to this market.

3. Failure to Acknowledge the Unique Characteristics of the Government Securities Market

With certain minor exceptions, S.936 tracks the statutory approach taken in the Securities Act Amendments of 1975, the legislation establishing the regulation of the municipal securities market and which created the Municipal Securities Rulemaking Board (the"MSRB"). The legislation, merely makes some minor adjustments to Section 15B of the Securities Exchange Act of 1934, and changes the name of the MSRB to the Public Securities Rulemaking Board. It implies a level of comparability between these two markets which, in fact, doesn't exist. To assume that by adding a few representatives of the government securities industry to the MSRB, that one could effectively regulate both markets might sound academically attractive but is shortsighted and raises substantial risks. In our view, the structure and functioning of the municipal and government securities markets are so different (as more fully detailed in Appendix I attached hereto) as to make application of the approach described in S. 936 unsuitable. More significantly, S. 936 fails to adequately acknowledge the macroeconomic issues raised when changes are proposed in a market which is integrally involved with the execution of monetary policy, fundamental to financing our national debt and so initimately involved in providing liquidity to our entire banking and international financial system.

4. Contrasting Environments in the pre-1975 Municipal Market and the Government Securities Market Today.

S. 936 mistakenly assumes that the legislative approach enacted in 1975 to address the problems in the municipal securities market is now appropriate for application to the government securities market. However, the problems existing in the municipal securities market in the early 1970s were quite different from the particular areas of vulnerability facing the government securities market today.

In the early 1970s, several fraud actions were brought by the SEC against municipal securities professionals for improper and unethical trading and selling practices, most of them involving individual investors. At the same time, increased numbers of individual investors, many lacking the financial sophistication of institutional investors, were participating in the municipal markets. These factors indicated a greater need for individual investor protection. Even today, approximately 80 percent of municipal securities are sold to individual investors.

On the other hand, the government securities market remains a wholesale, not a retail market. It is still dominated by institutional investors (more than 80 percent of government securities are owned by institutions). In addition, the pattern of abuse which existed in the municipal securities market, e.g., fraudulent trading and selling practices, are quite different in nature from the imprudent activities we have witnessed in the government securities market. The problems in the government market have not been ones involving market manipulation or widespread deception of individual investors. Given the narrow conjunction of imprudent investors and unregulated dealer insolvencies that gave rise to the problems in the government securities market, the approach taken in S.936 misses the mark and risks diffusing the attention that should be focused on dealer capitalization requirements and the prevention of fraud in connection with repurchase transactions.

CONCLUSION

In closing, we would like to emphasize that we believe a multi-faceted response is necessary to address current market concerns. This response should include the development of new legislation granting specific rulemaking authority to the Federal Reserve Board over all government securities dealers and brokers. Concurrently, we suggest regulatory responses by the appropriate customer (e.g., repo investor) regulatory bodies establishing more defined prudent investment management standards.

In addition, we believe that in considering any change in the level of regulation or supervision of activities in the government securities market, one must carefully balance the potential costs of regulation against the benefits the public hopes to realize. Therefore, we strongly suggest careful consideration of any proposed regulatory or legislative change, particularly given the risks to both the world economy and the public associated with any impairment of the efficient functioning of the government securities market. We should note that in the event that overhead and administrative costs of regulation result in fewer market participants, the cost to the public could be substantial. We stand ready to provide whatever assistance is necessary or appropriate.

APPENDIX I

COMPARISON OF THE GOVERNMENT AND MUNICIPAL SECURITIES MARKETS

Introduction: This Appendix highlights the differences between the municipal and U.S. government securities markets in light of several recent legislative proposals suggesting the expansion of the rulemaking authority and jurisdiction of the Municipal Securities Rulemaking Board ("MSRB") into a Public Securities Rulemaking Board ("PSRB"). Under this concept, the PSRB would have rulemaking authority over all government related securities. This would include all U.S. government securities and government sponsored agency securities (e.g., GNMA, FNMA, FHLMC, SLMA etc.). However, for purposes of simplicity we have structured this comparative analysis referencing only the difference between U.S. government and municipal securities.

	U.S. Government Market	Municipal Market
Issuer	The U.S. Government	Approximately 44,000 issuers; States; localities; school districts; colleges & universities; port authorities; utilities; housing finance agencies; not for profit hospitals; local economic development authorities; special districts
Size of Market		
1984 Net Increase in Amount Outstanding	$186 billion	$67 billion
Amount Outstanding Year End 1984	$1.2 trillion	$539 billion
Use of Bond Proceeds		
	- Finance Treasury's cash imbalances - Rollover maturing debt	Elem. & Secondary Education; College,

	U.S. Government Market	Municipal Market
Use of Bond Proceeds (cont'd)		Univ., Higher Educ.; College, Univ., Dorm. & Dining; Vocational Education; Educ., Libraries, Museums; Student Loans; Roads, Toll Roads; Bridges; Tunnels; Road, Sewer, Drainage; Ports & Port Facilities; Harbor & River Improvements; Airports; Transit Systems; Parking Facilities; Pollution Control (Non IDB); Water-Utilities & Conservation; Sewer-Sanitation Districts; Sewer-Drainage Districts; Electric Power Plant; Gas; Flood Control; Multi-Family Housing; Single-Family Housing; Hospitals; Mental Institutions; Clinics & Other Medical Facilities; Asylums & Homes for Disabled; Office Bldg., Court House; Armories; Arsenals; Correctional Institutions; Gen. Public Land Acquisitions; Fire Stations & Equipment; Civil Defense; Parks, Playgrounds, Beaches, Swimming, Golf, Tennis Facilities; Recreational Centers, Theaters Etc.

	U.S. Government Market	Municipal Market
Description of Securities	Treasury Bills, Notes and Bonds; Full faith & credit of U.S. Government; taxable only at federal level	General obligation Bonds - full faith & credit of issuing state & locality Revenue Bonds -secured by revenues of project being financed All securities tax-exempt at Federal level Specific types of Revenue bonds: Student Loan Bonds Private exempt entity bonds Industrial Park Bonds Small Issue IDBs Exempt Activity IDBs: (Secured with payments from private entities) -Residential rental projects - Sports facilities - Convention facilities - Airports, docks, etc. - Sewage or waste disposal facilities Pollution control facilities - Water furnishing facilities - Hydroelectric generating facilities - Mass commuting vehicles - Local district or cooling facilities - Electric & gas facilities

	U.S. Government Market	Municipal Market
Schedule of Issuances	A reasonably predictable and structured schedule of issuances determined by the Treasury Dept. For example: -3 and 6 month bills auctioned weekly on Mondays -52 Week bills auctioned every four weeks -3 year, 10 year notes and 30 year bonds included in Treasury's regular mid-quarter refundings (Feb., May, Aug., & Nov.)	Schedule of issuance of securities depends upon demand for services as well as market conditions
Underwriting	Auction Process: Some Dealers submit competitive bids, that is, bids stating a specific yield. Other dealers submit non-competitive bids to purchase securities at the average yield.	Competitive bidding for most General Obligation offerings: Groups of underwriters bid competitively for an issue. Negotiated underwriting for most Revenues Issues: issuer generally contracts with specific underwriters to bring issue to market. In both cases, syndicates are formed for pricing and distribution purposes.
Secondary Market	Very liquid; substantial majority of securities in book entry; transactions are completed in seconds; up to $200 billion per day is exchanged	Not very liquid; trades involve high transactions cost and require more time to complete; secondary market volume is unknown

	U.S. Government Market	Municipal Market
Dealers	36 Primary Dealers- report positions daily to the Fed Reserve of NY; registered broker dealers regulated by the SEC; dealer banks regulated by the Comptroller of the Currency, the FDIC or the Federal Reserve Board depending on structure of institution; other dealers under no formal federal regulation	All dealers registered with the Municipal Securities Rulemaking Board
Special Role of Fed	Fiscal agent for the Treasury; Conducts open market operations to execute domestic monetary policy; also invests in Treasury securities on behalf of foreign central banks	
Dealer Financing	Repurchase agreements	Broker loans
Investors	At end of 1983:	At end of 1984:
Percentage of amount outstanding	18% Private Financial Institutions (commercial banks, mutual savings banks and insurance cos.) 17% U.S. Government Accounts 12% Foreign Institutions 11% Federal Reserve 10% State & Local Governments 9% Individuals 3% Corporations 18% Other (includes savings and loans, corporate pension trust funds, credit unions, mutual savings banks)	38% Individuals 32% Commercial Banks 16% Property & Casualty 8% Mutual Funds

Senator D'AMATO. Mr. Kelly, first of all, let me thank you for your thoughtful presentation.

Second, let me commend you for coming forward in an attitude and in the manner which lends some very real input and very constructive suggestions to the problems that exist. It's very easy to just simply take the line that we should not do anything that would impair the flexibility and the cost effectiveness of the marketplace. We recognize that certainly the Congress does not want to do that, but I consider that almost a nonstatement. I mean, that presupposes that the Congress would intrude in such a manner that would be injurious and therefore the Congress should not even entertain the idea of attempting to deal with the deficiencies that may exist.

VERY CONSTRUCTIVE SUGGESTIONS

Your presentation went well beyond what I consider to be an inadequate presentation if one were to simply linger on that one point which I might suggest to you we have had suggested by more than one witness. You have come forward with very constructive suggestions as to how to deal with the deficiencies that exist—adequate capital requirements, registration of those who are undertaking this important business, the utilization of the present structure that we have by way of the regulatory authorities in such a manner as to not unduly impede but yet will be there to provide the onsite inspection and the enforcement activities that could help minimize the kinds of losses that we have seen, the kind of frauds that we have seen, and also see to it that those who do not have the experience or the capital are not permitted to undertake these kinds of activities.

So I am deeply appreciative of your sensitivity and the association's sensitivity to this important area and you at least give to the committee some effective tools by which to begin to fashion an approach because I do believe that there is in the Congress, as I have indicated before, a very strong move to say, we've got to do more and there are deficiencies.

In that mode and in that zeal to correct some of the abuses, we don't want to move too far afield so that we might do the very thing that we certainly do not want to do, and that is, to impede the orderly flow of the market and the market reacting in such a manner that finally it would be injurious to all.

So let me ask you something in terms of customer attitudes, because you have lived this. You're there on the battle line, so to speak, and of course you do head a private firm as well. In other words, you are here today in your capacity as the chairman of the Government and Federal agency securities division of the Public Securities Association, but you are also an individual broker; is that correct?

Mr. KELLY. I am president of a primary dealer in Government securities.

Senator D'AMATO. So you would probably be in a better position—what was the reaction—was there an overreaction, let's say, when we had ESM and some of the other failures in the marketplace, and are we apt to see any more examples? What did the marketplace do as a result of those initial revelations?

Mr. Kelly. The early reaction by most market participants, Mr. Chairman, was one of disbelief. In terms of what has happened since then, I think it is fair to say that existing regulatory agencies as well as virtually all customers are reviewing their business and trading practices, particularly as they may relate to repurchase transactions. They are also reviewing—individual investors are reviewing the dealers with which they do business, both the dealers and their creditworthiness, which is a very healthy development.

Senator D'Amato. So the small municipality or the local school board, or a town, they are now looking with greater care to the dealer that they are actually transacting their business with, checking reputation, not just yields?

Mr. Kelly. This is our sense, yes.

Senator D'Amato. You suggested—and we heard Senator Riegle raise the question about whether or not it might be necessary to have legislation that would require actual physical transfer of the asset or possession of the security.

In your testimony you suggested that there are practices in the industry that certainly adequately take care of that problem if they are followed.

Would you care to put on the record the kinds of things or the activities that that would substitute or make it not essential to have that take place because I can just envision the problems in terms of transfers of securities of actual possession—they would have to be monumental and very, very, very costly.

Mr. Kelly. Very costly, indeed.

Senator D'Amato. Well, what kind of provisions do you make for that that would make that legislation meaningless or certainly not necessary?

Mr. Kelly. The central point concerns a perfected security interest in a repurchase agreement and in order to obtain a perfected security interest there must be a transfer of title to the securities in question. We believe that present segregation policies allow for that transfer of title without necessitating mandatory delivery of securities to either the investor or a third party.

If the Federal Reserve is granted rulemaking authority in this area, this undoubtedly would be looked into quite broadly with specific rules developed to ensure investor protection.

In the existing environment, I must say I would find it very difficult to justify to my constituents, my stockholders or others, if I was a small investor, as to why I was not taking collateral from a dealer that presently is unsupervised or unregulated in any way. I think that for all regulated and supervised dealers, particularly primary dealers in Government securities, investors should be far less concerned about actually taking delivery of collateral.

Senator D'Amato. You presuppose that they are properly segregating the actual instrument?

Mr. Kelly. Yes.

Senator D'Amato. Let me ask you this. Describe for me if you would your relationship as a primary dealer—you're one of the 30-plus who are primary dealers—with the marketplace and with other dealers, secondary dealers?

RELATIONSHIP AS A PRIMARY DEALER

Mr. **Kelly**. As the Treasury securities market is the cornerstone of the U.S. capital market, the primary dealers are the cornerstone of the Treasury securities market. We have a business relationship with the Federal Reserve Bank of New York whereby we must meet certain responsibilities to obtain a status of primary dealer. We have the responsibility of underwriting Treasury securities at the primary auction. We have the responsibility of maintaining a secondary market in all Treasury issues. This is where we interact with secondary dealers and investors. We act as the conduit, if you will, between the Treasury's auctions consequently distributing these securities to other dealers and investors.

Senator D'**Amato**. To give me a better sense of how this operates, in any 1 day would you as a primary dealer or have you ever taken a position, let's say, with the Treasury of undertaking 2 billion or 1 billion or 3 billion dollars' worth of activity yourself?

Mr. **Kelly**. Our specific firm?

Senator D'**Amato**. Yes.

Mr. **Kelly**. We have taken positions——

Senator D'**Amato**. What's the largest position you have ever taken or what area, about?

Mr. **Kelly**. I don't know if my stockholders would appreciate me telling this, but I would say that we will take substantial risks.

Senator D'**Amato**. What I'm suggesting is, in other words, you're not too different from others. In what area, sometimes does it reach $1 billion a day?

Mr. **Kelly**. Yes.

Senator D'**Amato**. OK. I think it's important that we have that understanding and when I say understanding so that the record will reflect that. We hear primary dealers and we hear that maybe there will be trading in the area of $80 billion in any given day, but a primary dealer may take a position of as much as $1 billion in a day; is that correct?

Mr. **Kelly**. That is right, and substantially more in some cases.

Senator D'**Amato**. I understand that. I'm not going to ask you what your largest was.

Now let's follow the step. You've just taken that position at an auction. What do you do then? What happens?

What does the primary dealer then do? You say you have the secondary dealer and they're your outlets; is that correct?

Mr. **Kelly**. That is right. If we have taken such a position, it would have been taken on the basis that, first of all, hopefully prices are going to rise and/or second that we will be able to distribute these securities to other dealers and investors. The market is so efficient and the spread so narrow and competition is so great, it's very difficult for us to have an advantage over other primary dealers, but all of us collectively will endeavor to distribute the securities that we have underwritten.

In that process, it is important that the financing mechanism be an efficient one affording us the least costly means to carry our positions while we are making this distribution. The market is just so active, Mr. Chairman, that it takes a very, very short period of time for us to distribute even a large position if we care to do it quickly.

Senator D'AMATO. When you say a short period of time, what are we talking about, in a matter of hours or days?

Mr. KELLY. A very substantial position could be liquidated in a matter of hours on most days not affecting the price structure significantly. Generally speaking, our firm takes a somewhat longer approach and more of an investment posture than with the thought of buying something and selling it for an immediate profit or loss for that matter. We try to think perhaps more in terms of 1 to 2 weeks in distributing what we have purchased.

Senator D'AMATO. What does your firm look for. You heard President Corrigan speak about people knowing the people they're doing business with. As you do business with your secondary markets, is that part of your undertaking, a long-term relationship with established firms, et cetera?

Mr. KELLY. All primary dealers over time have developed longstanding relationships with their customers and they are built on mutual trust. Many have different criteria, though, in which they try to measure the creditworthiness of their counterparties. We are particularly conservative in our company.

Senator D'AMATO. If someone walked in and said they wanted to do business with you and they were going to be a secondary dealer, what would you look for? Do you have certain standards that at least your company undertakes, capital, et cetera?

Mr. KELLY. We would first of all like to know how long they have been in business. Second, we would want to know about their principles. Third, we would look at their capital. We would be concerned with the consistency of their performance or their earnings. We would talk to their bankers and other dealers who know them to get a sense for their commonsense approach to business. There are a number of areas that aren't specific, but when you add them all up it's substantial.

Senator D'AMATO. So what we're really saying is in spite of whatever legislative actions that we undertake, in terms of registration of all those who deal in Federal securities, which I take it from your statement you have advocated, in the final analysis it will also come down to those good established business principles that you have and other firms have been undertaking in addition to whatever legislative initiatives that are going to really be the hallmark.

Mr. KELLY. No question, Mr. Chairman. No amount of regulation is an effective substitute for sound business and trading practices.

Senator D'AMATO. Mr. Kelly, let me thank you again for the thoughtfulness and the cogency of your presentation and for having, I think, undertaken and gone a step beyond that which you could have and which others have, that is to say, there's a problem but don't regulate too much. When we say what's too much or how much regulation or where should it be, they say, "Well, I can't tell you." I'm very appreciative of your efforts individually and that of the association.

This committee stands in recess.

[Whereupon, at 12:05 p.m., the hearing was adjourned.]

[Written questions and answers follow:]

QUESTIONS FOR MR. GERALD CORRIGAN
PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK
SUBMITTED BY SENATOR ALAN CRANSTON

1) MR. CORRIGAN, WOULD YOU EXPLAIN THE PURPOSE OF THE PRIMARY DEALER LIST WHICH IS COMPILED BY THE FEDERAL RESERVE BANK OF NEW YORK?

2) BY MAKING THE PRIMARY DEALER LIST PUBLIC, IS IT THE BANK'S INTENTION THAT THIS LIST BE USED AS A MEANS OF VERIFYING THE CREDIT-WORTHINESS OF THOSE INSTITUTIONS LISTED, I.E., IS THE BANK STATING THAT IT IS "SAFE" TO DO BUSINESS WITH INSTITUTIONS WHO ARE PRIMARY DEALERS?

3) DO YOU CONSULT EXISTING PRIMARY DEALERS BEFORE ADMITTING A NEW COMPANY TO PRIMARY DEALER STATUS?

4) HAS THERE EVER BEEN AN OCCASION WHEN THE NEW YORK FEDERAL RESERVE BANK HAS REFUSED TO DO BUSINESS WITH A COMPANY ON THE PRIMARY DEALER LIST? IF YES, INDICATE REASONS?

IF YES, HAS THE BANK MADE ANY PUBLIC ANNOUNCEMENT CONCERNING THE FINANCIAL STATUS OF SUCH PRIMARY DEALER?

5) WOULD YOU AGREE THAT THERE ARE A LARGE NUMBER OF INSTITUTIONS WHICH ARE FULLY CREDIT-WORTHY BUT WHO HAVE CHOSEN NOT TO BECOME OR APPLY FOR PRIMARY DEALER STATUS?

6) AS A GENERAL PRINCIPLE, WOULD YOU AGREE WITH THE PROPOSITION THAT THE MARKET IN GOVERNMENT SECURITIES WOULD FUNCTION AT ITS OPTIMUM IF ALL PARTIES WHO HAVE THE FINANCIAL ABILITY TO DO SO HAVE EQUAL ACCESS TO TRADING, AT LEAST IN THE SECONDARY MARKET?

7) DO YOU SEE ANY REASON WHY FIRMS WHICH ARE NOT PRIMARY DEALERS SHOULD BE EXCLUDED FROM FULL ACCESS TO TRADING IN THE SECONDARY MARKET FOR GOVERNMENT SECURITIES IF THEY HAVE ADEQUATE CAPITAL, GOOD MANAGEMENT AND ARE TRUSTWORTHY?

8) ARE YOU AWARE THAT THE PRIMARY DEALER LIST HAS BEEN USED AS A DEVICE TO LIMIT ACCESS TO COMPLETE AND FULL TRADING IN THE SECONDARY MARKET FOR GOVERNMENT SECURITIES?

9) MORE SPECIFICALLY, ARE YOU AWARE THAT THERE ARE CERTAIN "BROKERS", WHO EFFECT TRADES THROUGH THE USE OF SCREENS SHOWING OFFERS TO BUY AND SELL GOVERNMENT SECURITIES, WHO HAVE LIMITED THE USE OF THE SCREENS AND THE ABILITY TO TRADE TO FIRMS WHO ARE PRIMARY DEALERS?

10) DOES THE FEDERAL RESERVE BANK OF NEW YORK NOW, OR HAS IT EVER ENCOURAGED (OR CONDONED) THE USE OF THE PRIMARY DEALER LIST FOR THIS PURPOSE?

11) WHAT ARE THE REQUIREMENTS FOR BECOMING A PRIMARY DEALER?

12) WHY DOESN'T THE NEW YORK FEDERAL RESERVE BANK PUBLISH A DOCUMENT CLEARLY STATING THE CRITERIA FOR BECOMING A PRIMARY DEALER?

13) DOES PARTICIPATION BY PRIMARY DEALERS IN THE AUCTION PROCESS AND IN THE OPEN MARKET TRANSACTIONS VARY SIGNIFICANTLY?

14) DO YOU HAVE ANY RECORDS SHOWING THE PARTICIPATION OF EACH PRIMARY DEALER AT GOVERNMENT AUCTIONS AND IN OPEN MARKET TRANSACTIONS? IF SO, COULD YOU SUPPLY THE COMMITTEE WITH SUCH DATA?

15) WHAT IS THE LONGEST TIME PERIOD WHICH ANY COMPANY HAS BEEN CONSIDERED AN APPLICANT FOR PRIMARY DEALER STATUS?

(A) WHY WAS THIS PERIOD SO LONG?

(B) IS THERE A PROCEDURE IN PLACE FOR APPLICANTS FOR PRIMARY DEALER STATUS TO BE PROMPTLY NOTIFIED OF ACCEPTANCE OR REJECTION?

(C) DOES THE FEDERAL RESERVE BANK FOLLOW THE ADMINISTRATIVE PROCEDURE ACT IN THE APPLICATION PROCESS FOR PRIMARY DEALER STATUS? IF SO, SHOULD THIS BE REQUIRED?

16) YOU AND THE FED HAVE QUITE A CHEERING SQUAD FROM SOME PRIMARY DEALERS, THE FED BANK MUST BE DOING SOMETHING RIGHT IN NEW YORK? MAYBE YOU COULD TELL US WHAT IS THIS GREAT ATTACHMENT THAT SOME OF THESE PRIMARY DEALERS HAVE TO THE FEDERAL RESERVE BANK OF NEW YORK?

THEY WANT A MARRIAGE HOWEVER, THE FED APPEARS TO BE A RELUCTANT BRIDE HERE, YOU WON'T SAY YOU WILL AND YOU WON'T SAY YOU WON'T?

WHERE IS THIS ALL GOING TO LEAD, IT SEEMS TO ME THE FED DOESN'T WANT THIS NEW INCREASED REGULATORY ROLE SOME OF THE PRIMARY DEALERS ARE CALLING FOR?

17) THESE PROBLEMS IN THE UNREGULATED GOVERNMENT SECURITIES AREA HAVE BEEN GOING ON SINCE THE MID SEVENTIES, WHY HASN'T THE FED SPOKEN UP AND ASK FOR STATUTORY AUTHORITY PREVIOUSLY OR MADE SOME SUGGESTIONS TO CONGRESS ON WHAT IS NEEDED HERE PRIOR TO THESE RECENT FAILURES? INDEED YOUR ONLY RESPONSE HAS BEEN TO CALL FOR VOLUNTARY CAPITAL GUIDELINES. YOUR RESPONSE HAS BEEN MINIMAL COMPARED TO THE ENORMOUS MAGNITUDE OF FINANCIAL LOSS THAT HAS BEEN INFLICTED ON THE PUBLIC BY THESE UNREGULATED SECURITIES DEALERS.

18) Now under Mr. Kelly's proposal the Federal Reserve would go from regulating the 36 primary dealers to regulating 100 to 200 or more previously unregulated government securities dealers. Would this interfere with your carrying out the monetary policy functions of the Oepn Market Committee of the Federal Reserve Board?

19) According to the 1980 SEC-Fed-Treasury Study, the Municipal Securities Rulemaking Body in its first full year of operation (1976) had expenses of $704,584 reflecting salaries, meetings, travel, etc. In 1979 the MSRB had expenses of $866,323 - a small increase over the previous year.

The NASD in its role of inspection and enforcement under the new MSRB in 1976 added 46 examiners to its nationwide staff at a cost of $600,000 in order to provide additional regulatory coverage for approximately 650 existing and 200 new municipal securities firms. These regulatory inspections covered every aspect of the dealers business. Allocation of the $600,000 among the more than 200 new firms resulted in a per firm cost in the range of $3,000 per firm for regulation.

In 1978 the NASD spent approximately $10.6 million for on-site inspections and review of its 2,813 members or about $3,800

PER MEMBER. THESE FIGURES INDICATE THAT THE KIND OF REGULATION AND OVERSIGHT PROPOSED IN S. 936 DOES NOT HAVE TO BE OVERLY EXPENSIVE, ESPECIALLY WHEN COMPARED WITH THE ENORMOUS PROFITS MADE IN THIS BUSINESSES.

DO EITHER OF YOU HAVE ANY FIGURES ON POSSIBLE COST OF REGULATION UNDER S. 936? OR IF THE FEDERAL RESERVE ASSUMES THE ROLE AS REGULATOR?

20. THE PRIMARY DEALERS HAVE CONSISTENTLY TOLD US THAT THEY SHOULD BE REGULATED SEPARATE AND APART FROM OTHER GOVERNMENT SECURITIES DEALERS BECAUSE OF THEIR SPECIAL RELATIONSHIP WITH THE FEDERAL RESERVE BANK OF NEW YORK. I WOULD LIKE YOU TO LOOK AT OUR BILL S. 936 AND SET OUT FOR ME ALL OF THE AREAS WHERE THERE COULD BE A SIMILAR REGULATORY STRUCTURE WITH MUNICIPAL SECURITIES DEALERS (I.E. REGISTRATION OF BROKER-DEALERS, REPORTING, OVERSIGHT, RECORDKEEPING, ACCOUNTING, DISCLOSURE, ETC) WOULD BE POSSIBLE.

(A) WOULD YOU MAKE A SEPARATE LIST OF AREAS IN WHICH YOU VIEW COMMON REGULATION TO BE IMPRACTICAL; OR OF ACTIVITIES THAT ARE PERFORMED BY PRIMARY DEALERS THAT HAVE SO SPECIAL A RELATIONSHIP TO THE AUCTION PROCESS THAT YOU FEEL SHOULD ONLY BE REVIEWED BY THE FEDERAL RESERVE BOARD?

FEDERAL RESERVE BANK OF NEW YORK
NEW YORK, N.Y. 10045
AREA CODE 212 791-6173

E. GERALD CORRIGAN
PRESIDENT

June 24, 1985

The Honorable Alan Cranston
United States Senate
Committee on Banking,
  Housing and Urban Affairs
Washington, D.C. 20510

Dear Senator Cranston:

Following the May 9 hearings of the Committee on the Government securities market, you asked that I address some additional questions for the record. This letter responds to that request.

As you know, the Federal Reserve Bank of New York ("New York Fed") is directly involved in the Government securities market for several reasons. The New York Fed purchases and sells Government securities to implement monetary policy. These open market operations are the primary vehicle used by the New York Fed in seeking to influence the growth of money and credit. The New York Fed also acts on behalf of approximately 150 foreign central banks and other foreign official institutions in the market. All New York Fed market transactions in Government securities--whether for its own account or for the account of foreign official institutions--are conducted only with the primary dealers.

The origins of the New York Fed's role in providing a form of surveillance over the primary dealers were, in part, based on one of the oldest precepts in trading--"know your counterparty." Well before the list of primary dealers was made public in 1960, the New York Fed made efforts to assess the financial strength and creditworthiness of the dealers with whom it did business.

As described in my statement before the Committee, several factors go into the decision to add a dealer to the list of daily reporting "primary dealers." Among the various statistical measures, we pay particular attention to volume of trading activity with customers. We also expect the primary dealers to be significant participants in the Treasury's auctions.

The status of primary dealer is not gained through a formal application. Rather, once a firm indicates its intention to seek primary dealer status and we conclude that there is some reasonable basis to expect that the firm has the potential to meet the criteria, we will begin to collect data from that firm regarding the volume and nature of its trading, its financial condition and other information. There is no systematic practice of consulting existing primary dealers before making the decision to do business with an additional dealer. However, we do make inquiries of a few primary dealers, clearing banks, and other regulators in the process of reaching judgments about the reputation and character of an aspiring new primary dealer, just as any prudent market participant would check references.

The New York Fed does not follow the Administrative Procedure Act in the application process for primary dealers, and we do not believe this should be required. As noted above, the process does not involve a formal application, but the procedure is reasonable and fair.

The length of time between first seeking a listing as a primary dealer and actually being listed varies considerably, but the interval has on occasion stretched over a few years, largely because of the amount of time required by a particular aspiring dealer to achieve the broad-based pattern of trading activity associated with primary dealer status.

The emergence of the list of primary dealers as a public document occurred in 1960 as an adjunct to an effort to receive more information from the primary dealers about their transaction volume. In 1960 the New York Fed instituted a formal reporting system in which primary dealers were requested to provide information on their transaction volume according to type of customer. In order to distinguish the amount of "professional" trading from the distribution of securities to customers, dealers were asked to report separately their transactions with other reporting dealers and their transactions with all other customers. The list of reporting dealers was distributed so that dealers could know the identities of the other reporting dealers, and, so, categorize their transaction volume appropriately.

The New York Fed believed in 1960, and continues to believe, that data on transaction volume broken out by type of counterparty is useful. The amount of a dealer's trading activity with its customers--as opposed to other primary dealers--reveals whether the dealer is maintaining a broad and active two-way market, a criterion for becoming a primary dealer. Breadth and amount of activity in market-making is used by the New York Fed as a criterion for two reasons. Broad and active market-making by dealers contributes to the smooth and orderly functioning of the market for Government securities. As a participant in the Government securities market, the New York Fed's day-to-day business is facilitated by a smoothly functioning and well-ordered market. Thus, as a business matter we encourage dealers to make markets. Also, a smoothly functioning Government securities market makes it less costly for the Treasury to borrow by issuing Government securities, and an orderly market is obviously conducive to broad-based investor participation in the market.

Although a firm is on the list of primary dealers, the New York Fed might not actually trade with the firm at a particular point in time. A period of time may pass between when the dealer is first added to the list and when we first enter into trades with the dealer. While the occasions have been rare, there have been a few instances when the New York Fed has discontinued trading with a primary dealer and then later deleted the firm from the published list. Several of these instances resulted from a drop in the firm's volume of activity. In one case, we stopped trading with a firm over concerns about its operations. We do not make public our decision to discontinue trading with a firm since it may prove temporary in some cases. To make temporary suspensions public might well contribute to premature and possibly unwarranted consequences to the firm.

We are aware of the potential that some investors may use the primary dealer list as a shortcut method of assessing a dealer's creditworthiness, knowing that the New York Fed monitors the operations of those dealers. We have attempted to discourage this practice by stating that the list has been compiled for statistical purposes (as shown on the enclosed listing), that it is not a substitute for careful analysis of dealers by each market participant, and that it does not represent a stamp of approval of dealer creditworthiness.

Several of your questions related to the wholesale secondary market for Government securities--that is, the inter-dealer trading market. Most of the trading in this market is done through brokers rather than by dealer-to-dealer trading. The brokers display quotes on electronic screens without identifying the firm that is the source of such quotes. Thus, a dealer hitting a bid through the broker does not know the identity of the party on the other side of the trade. However, it does know that the other party is a primary dealer because, generally, only such dealers have access to the brokers' market.

The New York Fed does not advise or direct the brokers in their decision to offer a dealer access to the brokers' market. The decision as to which firms have access to the individual brokers' wires is a decision that is made by the broker based on its own assessment of business and credit criteria. We are prepared to confirm a firm's status as a primary dealer or aspiring primary dealer. Obviously, the individual brokers and the primary dealer participants in the market feel that primary dealer status is a useful criterion in making those judgments as to those firms that are granted access to the brokers' wires. However, we would certainly expect that brokers and those with access to the brokers' market would, in the normal course, make their own independent credit and related checks.

Another factor may also be at work here. Achieving primary dealer status could be interpreted by other primary dealers as evidence that an institution has made a long-term commitment to the entire market, in both good times and bad. These dealers need a liquid market where the counterparties will be willing to trade actively on a broad range of securities. Also, the anonymity of the brokers' market permits these dealers to move their large positions without disclosing their strategies.

Looked at in that light, I cannot say that it is unreasonable for the brokers to grant primary dealers access to the brokers' market. Yet, a clear dilemma arises. That is, on the one hand, I do not see that it is necessarily desirable to limit full access to the secondary wholesale market to dealers solely on the basis of the fact that the firm is or is not a primary dealer. On the other hand, I would be deeply troubled with arrangements that facilitate or encourage broad-based, if not universal, blind trading.

The problem is how do we square the circle. Solutions do not come easily. At one extreme, it is possible to conceive of the establishment of a formal exchange with all its trappings of margining and settlement procedures, but I do not see that such a massive change is warranted. At the other, it might be possible for brokers themselves to adopt new procedures whereby they could provide access to creditworthy dealers that are not primary dealers and/or to adopt procedures that would permit at least selective name give-up for some trading. However, any such steps would have to be weighed very carefully from the standpoint of the integrity and efficiency of the market as well as from the standpoint of insuring that market participants remain free to choose with whom they do business.

The participation of primary dealers at auctions of Treasury securities and in open market transactions undertaken by the Federal Reserve varies widely by individual firms based upon their size and capital base. As a condition of achieving and maintaining primary dealer status, each dealer is required to participate continuously in the process of underwriting Treasury securities. As a general rule, each dealer is expected to submit bids to the Treasury in a size commensurate with its participation in the market overall. Thus, a dealer which normally executes 1 percent of the overall volume of secondary trading would be expected to bid for a similar portion of an issue offered by the Treasury. In fact, most primary dealers exceed this standard and these dealers as a group generally underwrite between 35 and 75 percent of new issues sold by the Treasury. In intermediate and long-term issues this percentage tends to be well over 50 percent.

Open market operations by the Federal Reserve are, of course, conducted solely with primary dealers. All dealers participate on a regular basis in submitting bids on offerings in response to our requests, again in relationship to their size and capital position. The volume of transactions actually executed is based upon competitive performance and the amounts done by individual dealers vary widely in each operation and over time. In 1984, for example, when the Federal Reserve executed about $100 billion in outright transactions, dealers in the upper quartile of volume averaged about 5.6 percent of the total, while dealers in the lowest quartile averaged about 0.7 percent of the total. The largest participation by an individual dealer was about 8 percent.

Finally, you asked several questions about additional regulation of Government securities dealers and the effect it might have on the New York Fed's operations. In this regard, I would want to stress that, whatever the outcome of regulatory discussions, the New York Fed would hope to continue a surveillance role vis-a-vis the primary dealers. In my view, the assignment of additional regulatory responsibilities to the Federal Reserve would not interfere with the carrying out of the monetary policy functions of the Federal Open Market Committee. I should note that the results of SEC, Fed, and Treasury interagency discussions regarding market regulation are now being transmitted to the Congress by Chairman Shad. We believe that it is possible to design a regulatory program which is both practical and cost effective and which accomplishes its objectives without impairing the efficiency and liquidity of the Government securities market. I would expect the costs per dealer of such a plan to be of roughly similar magnitude to those presently incurred in connection with the regulation of other dealer firms, such as those supervised by self-regulatory organizations under the SEC.

I hope that this letter has been responsive to your questions and concerns. If you or your staff would like to discuss any of this in more detail, please do not hesitate to call me.

Sincerely,

/S/ E. Gerald Corrigan

E. Gerald Corrigan
President

Enclosure

LIST OF THE GOVERNMENT SECURITIES DEALERS REPORTING TO THE MARKET REPORTS DIVISION OF THE FEDERAL RESERVE BANK OF NEW YORK

Bank of America NT & SA
Bankers Trust Company
Bear, Stearns & Co.
Briggs, Schaedle & Co., Inc.
Carroll McEntee & McGinley Incorporated
Chase Manhattan Government Securities, Inc.
Chemical Bank
Citibank, N.A.
Continental Illinois National Bank
  and Trust Company of Chicago
Crocker National Bank
Discount Corporation of New York
Donaldson, Lufkin & Jenrette Securities
  Corporation
Drexel Burnham Lambert Government Securities Inc.
The First Boston Corporation
First Interstate Bank of California
First National Bank of Chicago
Goldman, Sachs & Co.
Greenwich Capital Markets, Inc.
Harris Trust and Savings Bank
E. F. Hutton & Company, Inc.
Kidder, Peabody & Co., Incorporated
Kleinwort Benson Government Securities, Inc.
Aubrey G. Lanston & Co., Inc.
Lehman Government Securities, Inc.
Manufacturers Hanover Trust Company
Merrill Lynch Government Securities Inc.
Morgan Guaranty Trust Company of New York
Morgan Stanley & Co. Incorporated
The Northern Trust Company
Paine Webber Incorporated
Wm. E. Pollock Government Securities, Inc.
Prudential-Bache Securities, Inc.
Refco Partners
Salomon Brothers Inc
Smith Barney Government Securities, Inc.
Dean Witter Reynolds Inc.

NOTE: This list has been compiled and made available for statistical purposes only and has no significance with respect to other relationships between dealers and the Federal Reserve Bank of New York. Qualification for the reporting list is based on the achievement and maintenance of reasonable standards of activity.

Market Reports Division
Federal Reserve Bank of New York
September 12, 1984

Public Securities Association
1110 Vermont Avenue, N. W.
Suite 1075
Washington, D.C. 20005
(202) 659-5850

PSA

August 22, 1985

The Honorable Alan Cranston
United States Senate
Committee on Banking, Housing
& Urban Affairs
Washington, D.C. 20510

Dear Senator Cranston:

The Public Securities Association's Primary Dealers Committee is pleased to respond to the follow-up questions presented in your recent letter relating to regulation of the government securities market. We recognize that the questions you presented preceded your co-sponsorship of S.1416, the "Government Securities Dealers Act of 1985," legislation which we believe is particularly well conceived and worthy of strong industry support.

QUESTION 1

The statement submitted at the May 9, 1985 hearings before the Senate Subcommittee on Securities presented the views of the Primary Dealers Committee, and not the official position of the full association. There are currently 36 members of the Primary Dealers Committee. Membership on this Committee tracks precisely the "list of government securities dealers reporting to the Market Reports Division of the Federal Reserve Bank of New York" and who meet the PSA membership criteria. Currently, this Committee consists of 15 banks or bank subsidiaries, 12 broker-dealers registered with the Securities and Exchange Commission and 9 unregistered dealers.

The Primary Dealers Committee did vote in favor of the position expressed at the hearing at a special meeting held on April 29, 1985. The vote in favor of the position was 31 to 3, with 2 firms absent. We did not take a specific vote either in favor or against S.936, although there was widespread opposition to it in its present form. The PSA Board of Directors is still

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considering whether the full association will take a position on this issue.

As expressed in our statement to the Subcommittee, we believe that the Federal Reserve Board should be granted rulemaking authority to develop regulations directed only to identifiable weaknesses in the marketplace. Secondly, we suggest that whatever legislative proposals are considered by the Congress be structured in such a fashion as to cause as little disruption to the efficiency of the marketplace as possible. We do not believe that it would be appropriate to impose a broad comprehensive regulatory scheme which is the approach suggested in S.936. Instead, we support S.1416, legislation which you have recently co-sponsored.

The regulatory approach suggested by the Primary Dealers Committee and followed closely in S.1416 has several advantages over the formulation proposed in S.936. First, it places rulemaking authority with the Federal Reserve which is the institution most familiar with the workings of the government securities market. Second, the rules in our approach specifically address identified weaknesses in the marketplace. These rules better insure the maintenance of integrity and financial responsibility of dealers in the government securities market and do not interfere with existing market and trading practices that work well. Third, enforcement is placed in the first instance with the primary regulator for the affected institutions, thereby minimizing costly overlapping regulation. For example, currently unregulated government securities dealers would be subject to rules promulgated by the Federal Reserve Board, at the same time they would be required to register with the Securities and Exchange Commission and enforcement responsibilities would be delegated to the NASD and the SEC.

If we were forced to live with S.936, we would offer the following suggestions for improving the bill. First, oversight responsibilities for approving any rules of the SRO should be the Federal Reserve Board and not the Securities and Exchange Commission. Secondly, the scope of regulation should be significantly narrowed and directed only to identifiable problem areas of the market. Lastly, if the Congress felt that an SRO approach was necessary, it should be separate and apart from any other currently existing self-regulatory or rulemaking bodies.

QUESTION 2

The Primary Dealers Committee believes that the best interests of the market and its customers would be served by legislation which establishes regulatory authority with the Federal Reserve Board for application to all government securities dealers and brokers. We do, however, believe that there should be instances in the rulemaking process where the Federal Reserve Board should be granted the flexibility to exempt classes or categories of dealers on specific rules. In addition, we believe that it may be appropriate for the Federal Reserve to formulate rules which would apply somewhat differently for different classes of dealers. The need for this type of flexibility in administering rules is already contained in S.936 and S.1416. In addition, there is precedent existing in application of the SEC net capital rule for this type of regulatory approach.

QUESTION 3

The question of over-regulation is one which must be viewed in a broader context than merely its effect on the Primary Dealers Committee. Overly-broad regulation could reconstruct a marketplace which is currently not in need of such fundamental revision.

We do agree that there are areas of weaknesses in the marketplace most particularly concerning the regulatory gap which exempts certain dealers from any formal regulation or supervision and certain procedures in the repo market that has allowed fraud to occur. However, there is a good deal more about this market that continues to operate extraordinarily well. Congress should only take action where it is necessary and not overly regulate a market which is so vitally important. As pointed out in our statement to the Subcommittee there are several fundamental differences between the municipal and government securities market which makes application of the MSRB structure inappropriate. We think the risks involved in imposing overly broad regulation is so significant that the Congress should specifically identify the problem areas and take action to address them and not risk unanticipated structural changes in the marketplace.

QUESTION 4

The Primary Dealers as the cornerstone of the government securities market are vitally interested in the question of regulation even if they were to be entirely exempt from the application of any regulatory structure. The nature of this marketplace is such that the primary dealers are continually transacting business with non-primary dealers. Any set of regulatory proposals which redefine the business and trading practices of the secondary dealers will have direct implications on the operations of the primary dealers and the entire government securities market.

I hope this letter has been responsive to your questions.

Sincerely,

Richard M. Kelly
Chairman
Primary Dealers Committee

RMK:nm